

1-1-2008

Securities industry developments - 2007/08; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

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AUDIT RISK ALERTS

Securities Industry Developments — 2007/08

*Strengthening Audit Integrity
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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Securities Industry Developments — 2007/08

*Strengthening Audit Integrity
Safeguarding Financial Reporting*

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

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1 2 3 4 5 6 7 8 9 0 AAG 0 9 8

ISBN 978-0-87051-714-3

Notice to Readers

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, the Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well.

This publication is an *other auditing publication* as defined in AU section 150, *Generally Accepted Auditing Standards* (AICPA, *Professional Standards*, vol. 1). Other auditing publications have no authoritative status; however, they may help the auditor understand and apply the Statements on Auditing Standards.

If an auditor applies the auditing guidance included in an *other auditing publication*, he or she should be satisfied that, in his or her judgment, it is both relevant to the circumstances of the audit and appropriate. The auditing guidance in this document has been reviewed by the AICPA Audit and Attest Standards staff and published by the AICPA and is presumed to be appropriate. This document has not been approved, disapproved, or otherwise acted on by a senior technical committee of the AICPA.

Susan M. Reed, CPA

Technical Manager

Accounting and Auditing Publications

Acknowledgments

The AICPA staff wishes to thank various members of the securities industry and the Stockbrokerage and Investment Banking Expert Panel for their essential contributions in creating this publication: Ronald Carletta, Al Goll, Dipti Gulati, G. Victor Johnson, Andrew Labadie, Anthony Lucarelli, Paul Nockels, Irina Portnoy, Marie Stewart, and Stephen Zammitti.

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How This Alert Helps You

.01 This Audit Risk Alert (alert) helps you plan and perform your securities industry audits. This alert can also be used by an entity's internal management to address areas of audit concern. This alert provides information to assist you in achieving a more robust understanding of the business, economic, and regulatory environment in which your clients operate. This alert is an important tool in helping you identify the significant risks that may result in the material misstatement of financial statements. Moreover, this alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

.02 This alert is intended to be used in conjunction with the AICPA *Audit Risk Alert—2007/08* (product no. 022338kk). This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com. You should refer to the full text of accounting and auditing pronouncements as well as the full text of any rules or publications that are discussed in this alert.

.03 *References to Professional Standards.* When referring to the professional standards, this alert cites the applicable sections as codified in the AICPA *Professional Standards* and not the numbered statements, as appropriate. For example, Statement on Auditing Standards (SAS) No. 54, *Illegal Acts by Clients*, is referred to as AU section 317 of the AICPA *Professional Standards*.

Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement

.04 An auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. An auditor's understanding of the entity and its environment consists of an understanding of the following aspects:

- Industry, regulatory, and other external factors
- Nature of the entity
- Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements
- Measurement and review of the entity's financial performance
- Internal control, which includes the selection and application of accounting policies

.05 The securities industry may be subject to specific risks of material misstatement arising from the nature of the business, the degree of regulation, or other external forces (for example, political, economic, social, technical, and competitive forces).

.06 The auditor should obtain an understanding of the entity's objectives and strategies and the related business risks that may result in material misstatement of the financial statements. Business risks result from significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies. Just as the external environment changes, the conduct of the entity's business is also dynamic,

and the entity's strategies and objectives change over time. An understanding of business risks increases the likelihood of identifying risks of material misstatement. However, the auditor does not have a responsibility to identify or assess all business risks. Most business risks will eventually have financial consequences and, therefore, an effect on the financial statements. However, not all business risks give rise to risks of material misstatement.

.07 After obtaining a sufficient understanding of the entity and its environment, including its internal control, an auditor should identify and assess the risks of material misstatement at the financial statement level and at the relevant assertion level related to classes of transactions, account balances, and disclosures based on that understanding.

.08 Understanding and properly addressing, as necessary, the matters presented in this alert will help you gain a better understanding of your client's environment, better assess risks of material misstatement of the financial statements, and strengthen the integrity of your audits.

Economic and Industry Developments

The State of the Economy

.09 When planning and performing audit engagements, an auditor should understand the economic conditions facing the industry in which the client operates. Economic activities relating to factors such as interest rates, consumer confidence, overall economic expansion or contraction, inflation, and labor market conditions are likely to have an impact on the entity's financial statements being audited.

.10 The U.S. real gross domestic product (GDP), the broadest measure of economic activity, measures output of goods and services by labor and property within the United States and increases as the economy grows. According to the Bureau of Economic Analysis, GDP increased at an annual rate of 2.9 percent in 2006, consistent with the pace of growth experienced in 2005 when GDP increased by 3.1 percent. During the first quarter of 2007, GDP increased by an annual rate of only 0.6 percent. However, according to second quarter preliminary estimates, GDP increased at an annual rate of 4.0 percent.

.11 The unemployment rate remained relatively unchanged during 2006, holding between 4.4 percent and 4.8 percent, with an annual average rate of 4.6 percent representing approximately 7 million people. The 2006 rates represent the lowest annual rate and total number of jobless since 2000, according to the U.S. Department of Labor, Bureau of Labor Statistics. During the first half of 2007, the unemployment rate averaged 4.5 percent. These data further demonstrate the economic growth the United States has experienced since the beginning of 2006.

.12 After a period of rising rates during the first half of 2006, the Federal Reserve kept its target for the federal funds rate at 5.25 percent for 10 consecutive meetings (June 2006–August 2007). At that time, the Federal Reserve indicated future federal funds rate adjustments would likely depend upon the outlook for economic growth and inflation. Since its August 2007 meeting, and in response to shaky financial market conditions, the Federal Reserve has taken several action steps. It announced that it would provide reserves as necessary through the open market to facilitate the orderly functioning of financial markets by promoting trading in the federal funds market at rates close to the 5.25

percent target rate. On August 17, 2007, it announced that financial market conditions had deteriorated, and tighter credit conditions and increased uncertainty have the potential to restrain economic growth. Then, at its September meeting, the Federal Reserve decided to lower its target for the federal funds rate by 50 basis points to 4.75 percent, citing increased uncertainty surrounding the economic outlook. The Federal Reserve also decided to decrease the discount rate by 50 basis points to 5.25 percent, to consistently keep the spread between the primary credit rate and the target federal funds rate at 50 basis points. Auditors should remain alert to developments in the financial markets and how they may affect your audit engagements.

.13 Although 2007 to date (up through early October) has been a year of records for the stock market, it is also a year that has seen the mortgage markets begin to unravel. Subprime mortgages have been blamed as one of the sources of the credit market problems, and the resultant illiquid (or less liquid) credit market conditions. And as the housing market weakens, it remains to be seen what effect this has on the stock market and the economy in general. The consensus at the time of this writing is that economic growth in the near future will slow down due to the increase in the cost of credit.

Industry Trends and Conditions

The Securities Industry

.14 The year 2006 was a record year for the U.S. securities industry. Pretax profits reached \$33.1 billion for 2006. That is 88.2 percent above the \$17.6 billion pretax profit that was earned in 2005 and 4.7 percent above the previous record of \$31.6 billion pretax profit set in 2000. In the first quarter of 2007, the industry reported pretax profits of \$7.7 billion. This 2007 first quarter figure was down 28.7 percent from the immediately preceding quarter and 1.6 percent below the same period in the preceding year. Despite the decrease, first quarter 2007 profits were the third best first quarter results on record.

.15 The markets this year have hit record high levels with significant declines in between. The Dow Jones Industrial Average (DJIA or Dow), NASDAQ Stock Market, Inc. (NASDAQ), and the Standard & Poor's 500 Index (S&P 500) rose from the beginning of the year, but hit significant lows in March and August of 2007. Despite the declines, all three markets hit record highs in July and again on October 1, 2007 (the last date considered at the time of this writing).

.16 The Dow started the year at 12,459.54. At the end of the second quarter of 2007, it was up 20.3 percent from a year earlier. The third quarter of 2007 has been a tumultuous period. In July 2007, the Dow closed above 14,000 for the first time ever, closing at 14,000.41 on July 19, 2007. It should be noted that it took only 59 days to go from the previous record of 13,000 to 14,000. Then, in August, the Dow dropped below 13,000 again—closing at 12,861.47 on August 15, 2007 (taking less than a month to decrease 1,000 points). By October 2007, the Dow again closed above 14,000—closing at 14,087.55 on October 1, 2007 (the last day considered at the time of this writing).

.17 The NASDAQ opened 2007 at 2,445.07. Its path during 2007 has been similar to the Dow in that it hit a high close of 2,720.04 on July 19, 2007, and then hit another high close of 2,740.99 on October 1, 2007. It also experienced a couple of large declines, closing at 2,340.6799 on March 5, 2007, and 2,451.07 on August 16, 2007.

.18 The S&P 500 closed above 1,400 for the first time in 6 years on November 17, 2006. After rising for several months, it fell below 1,400 again on March 5, 2007—closing at 1,374.12. After a volatile period, it closed above the 1,500 mark, closing at 1,547.04 on October 1, 2007.

.19 How 2007 will finish is as uncertain as the economy is currently. For more information on the markets, please refer to the Securities Industry and Financial Markets Association (SIFMA) Research Reports, which can be accessed at www.sifma.org/research/research_reports.html.

The Commodities Industry

.20 Global futures and options contract volume has continued to increase through 2006 and into 2007. In the first 8 months of 2007, volume on U.S. futures exchanges reached 4 billion contracts, a 33 percent increase from the same period in 2006. The volume of contracts traded on foreign exchanges increased 23 percent compared to the first 8 months of 2006. Trading volume in interest rate and equity products continued to account for more than half of worldwide trading volume.

.21 The growth in futures volume and markets is further reflected in increased customer funds held by entities registered with the Commodity Futures Trading Commission (CFTC) as futures commission merchants (FCMs) for trading on U.S. and foreign futures and options exchanges. The total amounts required under CFTC regulations to be held in segregated or secured accounts on behalf of FCM customers increased by \$9 billion from approximately \$139 billion as of August 31, 2006, to approximately \$148 billion as of August 31, 2007.

.22 The U.S. futures industry, in addition to the increasing volume and customer participation, also has experienced other significant changes through 2006 and into 2007. In 2007, the Chicago Mercantile Exchange (CME) and the Chicago Board of Trade (CBOT), the two largest contract markets designated by the CFTC, completed their merger. The new CME/CBOT combined organization, U.S.-based CME Group, Inc., is devoted to derivatives trading and clearing. Also, in 2007, InterContinental Exchange (ICE) acquired the New York Board of Trade (NYBOT) (now known as ICE Futures U.S.), and the Winnipeg Commodities Exchange.

Legislative and Regulatory Developments¹

.23 Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Broker-Dealer Guide), discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Broker-Dealer Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of

¹ Readers should be alert for updates, amendments, or other changes to the rules discussed in this section and for other recent developments related to regulatory activities. The brief summaries provided in this section of the alert are for informational purposes. Readers should refer to the full text of the regulations. In addition, not all regulatory activity is included in this publication. The complete text of Securities and Exchange Commission (SEC) rules, including those rules adopted subsequent to the publication of this alert, can be obtained from the SEC Web site at www.sec.gov; Commodity Futures Trading Commission (CFTC) rules at www.cftc.gov; Financial Industry Regulatory Authority (FINRA) rules at www.finra.org; and National Futures Association (NFA) rules at www.nfa.futures.org. See the "Industry Web Sites" table at the end of this alert for a list of Internet sources.

the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor would not otherwise choose to do so.

.24 The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934 (the Exchange Act). Qualifications and reports of independent accountants of FCMs and introducing brokers (IBs) are specified by Regulation 1.16 of the Commodity Exchange Act (CEA). Alternative regulatory frameworks have been created for consolidated supervised entities and over-the-counter derivatives dealers. Further, registered broker-dealers in U.S. government securities are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

.25 Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

.26 Certain regulatory activities and developments relevant to entities operating in the securities industry are presented in the following section. Presented first are developments arranged by subject, followed by developments by regulatory authority. Included are summaries of some rules the Securities and Exchange Commission (SEC), CFTC, and Self-Regulatory Organizations (SROs) have issued since the writing of last year's alert. In addition to reading the following regulatory matters, see the *AICPA Audit Risk Alert—2007/08*, the *Audit Risk Alert Independence and Ethics—2007/08*, and the *Audit Risk Alert SEC and PCAOB Alert—2007/08* for a discussion of current issues.

NASD and NYSE Regulation Combine Operations

.27 In November 2006, it was announced that the National Association of Securities Dealers (NASD) and the member regulation, enforcement, and arbitration operations of the New York Stock Exchange (NYSE or the Exchange) planned to combine operations. This consolidation occurred and created the largest nongovernmental regulatory organization for brokers and dealers of securities in the United States. The new organization has been named the Financial Industry Regulatory Authority (FINRA).

.28 The consolidation was approved by the SEC on July 26, 2007, and became effective July 30, 2007. According to the FINRA news release announcing the consolidation, the organization will conduct the regulatory oversight of 5,000 securities firms and 666,000 registered representatives. The organization will be responsible for rule writing, firm examination, enforcement and arbitration, and mediation functions, along with all functions that were previously overseen solely by NASD. This includes market regulation under contract for NASDAQ, the American Stock Exchange, the International Securities Exchange, and the Chicago Climate Exchange.

.29 The new organization, FINRA, emphasized that investor protection and market integrity are primary objectives. The organization will be investor-focused and more streamlined so that it will be better suited to the complexity and competitiveness of today's global capital markets. Furthermore, FINRA asserted that by eliminating overlapping regulation, establishing a uniform set of rules, and having oversight responsibility in a single organization, investor

protection will be enhanced while increasing the competitiveness of the financial markets. For more information on FINRA, visit www.finra.org.

Portfolio Margin Expanded Pilot Program Extended

.30 NYSE Rule 431, *Margin Requirements*, generally prescribes minimum initial and maintenance margin requirements. On July 14, 2005, the SEC approved, on a pilot basis expiring July 31, 2007, amendments to Rule 431 to permit the application of a risk-based margin requirement (portfolio margining) to certain eligible products (including listed broad-based securities index options, warrants, futures, futures options, and related exchange traded funds) as an alternative to strategy-based margin requirements. Amendments to Rule 726, *Delivery of Options Disclosure Document and Prospectus*, were also approved, requiring disclosure to and written acknowledgment from customers in connection with the use of portfolio margining. For more information, please refer to SEC Release No. 34-52031 and NYSE Information Memo No. 05-56. By separate orders, the SEC also approved a parallel rule filing by the Chicago Board Options Exchange (CBOE), and a related rule filing by the Options Clearing Corporation. See SEC Releases No. 34-52032 and No. 34-52030.

.31 On July 11, 2006, the SEC approved additional amendments to Rule 431 that:

1. Expanded the scope of products eligible for portfolio margining and cross-margining;
2. Conformed customer disclosure requirements under Rule 726 to comply with this expansion; and
3. Modified certain net capital requirements in connection with the maintenance of portfolio margin accounts.

.32 Collectively, these amendments are referred to as the Expanded Pilot. The Expanded Pilot broadened the scope of products eligible for portfolio margining and cross-margining to include listed security futures and listed single stock options. Further, the Expanded Pilot permitted customers of pilot participants to effect transactions solely in security futures and listed single stock options without maintaining the \$5 million equity requirement applicable to effecting transactions in all other eligible products. See SEC Release No. 34-54125 and NYSE Information Memo No. 06-57 for more information.

.33 On December 12, 2006, the SEC approved additional amendments to NYSE Rule 431, which permit the application of portfolio margining to an expanded universe of eligible products. In addition, amendments to NYSE Rule 726 eliminate the sample portfolio margining risk disclosure statement from the rule. However, the rule will continue to require member organizations to provide customers with a written disclosure statement in a form prescribed by the NYSE, as well as to receive from customers a signed acknowledgement (see Information Memo 07-27, *Sample Portfolio Margining Risk Disclosure and Acknowledgment Statements*, issued 03/17/2007). The amendments are effective April 2, 2007. See SEC Release No. 34-54918 and NYSE Information Memo No. 06-86 for more information.

.34 Also, on December 12, 2006, the SEC approved a rule change proposed by the CBOE, as amended, to broaden its Rule 12.4, *Portfolio Margin and Cross-Margin for Index Options*, to expand the scope of products that are eligible for treatment as part of CBOE's approved portfolio margin pilot program and to

eliminate the requirement for a separate cross-margin account. The scope of eligible products in the pilot is expanded to include margin equity securities, unlisted derivatives, listed options, and securities futures. See SEC Release No. 34-54919 for more information.

.35 On March 14, 2007, the SEC approved a Portfolio Margin Pilot Program for the NASD in SEC release 34-55471. The portfolio margin pilot program is substantially similar to margin rule amendments by the NYSE and CBOE. NASD provided the required disclosures and written acknowledgements in NASD Notice to Members 07-14 released in March 2007.

.36 On July 19, 2007, the SEC release 34-56107 extended the existing NYSE expanded pilot program until July 31, 2008. The CBOE expanded pilot program (SEC Release 34-56109) and the NASD Portfolio Margin Pilot Program (SEC Release 34-56108) were also extended to July 31, 2008.

.37 Portfolio margining is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a "security class" or "product group" as determined by a theoretical pricing model using multiple pricing scenarios. The goal of portfolio margining is to set levels of margin that more precisely reflect actual net risk. The eligible participant benefits from portfolio margining in that margin requirements calculated on net risk are generally lower than those that apply to specific positions or strategies. Accordingly, customers eligible to use portfolio margining will gain additional leverage. Broker-dealers will benefit from portfolio margining because it permits them to offer a more competitive financing to customers seeking to implement sophisticated equity trading strategies. As a trade-off, broker-dealers will be required to expend additional efforts to manage the higher credit and market exposures emanating from portfolio margining activities.

.38 As specified in NYSE Information Memo 06-86, member organizations, for which the NYSE is the Designated Examining Authority (DEA), seeking to participate in portfolio margining must provide written notification and receive approval from the NYSE prior to establishing a portfolio margining methodology. In this regard, member organizations are expected to establish written procedures for monitoring the risk associated with portfolio margin accounts; such procedures must incorporate a methodology for assessing any potential risk to the member organization's capital. Readers should refer to NYSE Information Memo 06-57, which contains the procedures that must be fully documented.

Anti-Money Laundering Update

.39 The SEC has added the Anti-Money Laundering (AML) Source Tool on its Web site to assist broker-dealers in complying with applicable laws and regulations. The tool is a compilation of key AML laws, rules, and guidance that assist broker-dealers in meeting their obligations. In addition, it contains a list of useful telephone numbers and Web sites. To access the AML Source Tool, go to www.sec.gov/about/offices/ocie/amlsourcetool.htm.

.40 On a related note, the Financial Crimes Enforcement Network (FinCEN) has delayed the implementation of a revised Suspicious Activity Report (SAR). The form was originally scheduled to become effective on June 30, 2007, and become mandatory on December 31, 2007. FinCEN will establish new effective and mandatory compliance dates for using the revised SAR

form in a future notice. FinCEN has also issued guidance "Suspicious Activity Report Supporting Documentation" (FIN-2007-G003) that clarifies items related to supporting documentation required under SAR regulations. This guidance can be accessed at the SEC AML Web site at the address listed previously.

Proposed Amendments to Financial Responsibility Rules for Broker-Dealers

.41 The SEC has proposed amendments to its customer protection, books and records, notification, and net capital rules for broker-dealers under the Exchange Act. In March 2007, the SEC released "Amendments to Financial Responsibility Rules for Broker-Dealers." The proposed rule changes address several areas of emerging concern regarding financial requirements for broker-dealers, including updating the financial responsibility rules and making certain technical amendments. The following explanations are intended to briefly summarize the proposed amendments, which in some cases are very technical. Please refer to SEC Release 34-55431 for a complete description of these amendments. The release can be accessed at www.sec.gov/rules/proposed/2007/34-55431.pdf.

Proprietary Accounts of Broker-Dealers

.42 This proposed amendment would require broker-dealers to treat accounts they carry for domestic and foreign broker-dealers in the same manner as customer accounts for purposes of the reserve formula of Rule 15c3-3. Because broker-dealers are not considered to be *customers* as defined in Rule 15c3-3, this amendment would require a separate reserve computation for proprietary accounts of other domestic and foreign broker-dealers in addition to the reserve computation currently required for customers. Also, a separate reserve account for the benefit of the domestic and foreign broker-dealers must be established by the carrying firm. See section II.A.1 of the release for details.

Banks Where Special Reserve Deposits May Be Held

.43 The proposed amendment would not allow cash deposits to be held at affiliate banks for the purpose of meeting reserve requirements with respect to customers or other broker-dealers. In addition, the proposal contains limits on the amount of cash reserves that may be maintained at any one nonaffiliated bank. The limitations would prevent a broker-dealer from maintaining a reserve deposit in the form of cash at a single unaffiliated bank that exceeds a percentage of the broker-dealer's or the bank's capital. The exclusion and limitation does not apply to deposits of securities. See section II.A.2 of the release for details.

Expansion of the Definition of Qualified Securities to Include Certain Money Market Funds

.44 Under the proposed amendment, certain money market funds (those that only invest in securities meeting the definition of *qualified security* in Rule 15c3-3) that also meet several other requirements may be used to replace cash held in the customer reserve account. This should decrease the burdens on those broker-dealers that would be impacted by the proposed amendment related to

customer reserve account cash deposits into affiliate and nonaffiliate banks, as discussed previously.

Allocation of Customers' Fully Paid and Excess Margin Securities to Short Positions

.45 The proposed amendment would require a broker-dealer to take prompt steps to obtain physical possession or control over securities of the same issue and class as those included on the broker-dealer's books as a proprietary short position or as a short position for another person. The result will be that the broker-dealer will no longer be able to monetize the value of the security and use the cash for proprietary activities. The action would be required when the short position has aged more than 10 business days (or more than 30 calendar days, if the broker or dealer is a market maker in the securities).

Treatment of Free Credit Balances

.46 The proposed amendment would make it unlawful for a broker-dealer to convert, invest, or otherwise transfer free credit balances unless the broker-dealer has obtained a specific order, authorization, or draft from the customer and only under the terms and conditions specified by the customer. With respect to situations where a broker-dealer is recommending a sweep of free credit balances to either a money market fund or a bank deposit account, the broker-dealer would need to first obtain a customer's permission to initiate or change a sweep option to or from a money market fund or a bank deposit account. Second, the broker-dealer would need to provide the customer with all notices and disclosures required by the self-regulatory organizations, which the broker-dealer is a member of, regarding the selected investment option and the deposit of free credit balances. Third, the broker-dealer would need to provide the customer with notice in the customer's quarterly statement that the money market fund or bank deposit account can be liquidated on the customer's demand and converted back into a free credit balance held in the customer's securities account. Fourth, the broker-dealer would need to provide the customer with notice of at least 30 calendar days before changing the product (for example, from one money market fund to another), the product type (for example, from a money market fund to a bank account), or the terms and conditions under which free credit balances are swept.

Importation of Rule 15c3-2 into Rule 15c3-3

.47 Due to the fact that the majority of Rule 15c3-2 is obsolete, the relevant portion would be merged into Rule 15c3-3, and the former Rule 15c3-2 would be deleted. Under this proposal, the requirement that the clearing firm inform customers of the amounts due to them and that such amounts are payable on demand would be added to Rule 15c3-3.

Aggregate Debit Items Charge

.48 According to the proposed amendment, if a broker-dealer computes its net capital pursuant to the "alternative method," the broker-dealer is currently required to reduce its total debits by three percent of debit balances in customer cash and margin accounts when computing its reserve requirement. The SEC proposes to change the required reduction from three percent to one percent of debit balances in customer cash and margin accounts for broker-dealers using the *alternative method*.

Proprietary Accounts Under the Commodity Exchange Act

.49 An amendment to Rule 15c3-3 would clarify that funds held in a commodity account meeting the definition of a *proprietary account* under CEA regulations are not to be included as *free credit balances* in the customer reserve formula.

Holding Futures Positions in a Securities Portfolio Margin Account

.50 The CBOE, the NYSE, and (more recently) the NASD have amended their margin rules to permit broker-dealer members to compute customer margin requirements using a portfolio margining methodology. Under these rules, a broker-dealer can combine securities and futures positions into the portfolio margin account. The SEC proposes to amend Rule 15c3-3 to provide Securities Investor Protection Act (SIPA) protection to futures-related cash and options on futures in a portfolio margin account. This is done mainly by amending the definition of "free credit balance" in Rule 15c3-3 to include the market value of the options on futures so that it is included in SIPA liquidation.

Documentation of Risk Management Procedures

.51 Under the proposed amendment, broker-dealers that have more than (1) \$1 million in aggregate credit items as computed under the customer reserve formula, or (2) \$20 million in total capital including subordinated debt would be required to make and keep current records documenting their implemented systems of internal risk management control. The proposal also would require the broker-dealer to maintain these records for three years after the date the broker-dealer ceases to use the system of controls. It is noted that the proposed changes do not require any minimum elements that would be required to be included in a firm's internal controls, or any particular issues that need to be addressed. Instead, the amendment is designed to ensure that broker-dealers clearly identify the procedures (if any) they use to manage the risks in their business.

Amendments With Respect to Securities Lending and Borrowing and Repurchase/Reverse Repurchase Transactions

.52 The SEC is proposing two amendments designed to improve the regulatory oversight of securities lending and repurchase (repo) transactions. The first would clarify that a broker-dealer providing securities lending and borrowing services is assumed to be acting as a principal and is, therefore, subject to the applicable capital deductions. The only way a broker-dealer can be considered an agent (and not a principal) is if certain steps are taken to disclaim principal liability. The broker-dealer must disclose the identities of the borrower and the lender to each other and obtain written agreements from each stating that the broker-dealer is acting as agent and, therefore, assumes no principal liability in connection with the transaction.

.53 The second proposal would require broker-dealers to notify regulators whenever the amount of money payable against all securities loaned or subject to a repurchase agreement, or the total contract value of all securities borrowed or subject to a reverse repurchase agreement, exceeds 25 times tentative net capital. For purposes of this calculation, transactions involving government securities (as defined in Section 3(a)(42) of the Exchange Act) are excluded. This would allow regulators to be able to respond more quickly in the event a firm is approaching insolvency.

Requirement to Subtract From Net Worth Certain Liabilities or Expenses Assumed by Third Parties and Nonpermanent Capital Contributions

.54 Under this proposed amendment, in computing net capital, a broker-dealer would be required to reduce net worth by the full amount of any liabilities related to its activities that have been assumed by a third party, if the broker-dealer cannot demonstrate that the third party has the resources independent of the broker-dealer's income and assets to pay such liabilities. Items that would evidence the third party's financial capacity are current audited financial statements, tax returns, or regulatory filings containing financial reports.

.55 In addition, capital that is contributed under an agreement giving an investor the opportunity to withdraw the contribution, or capital that is intended to be withdrawn within one year, would have to be recognized by the broker-dealer as a liability.

Requirement to Deduct the Amount a Fidelity Bond Deductible Exceeds Self-Regulatory Organizations Limits

.56 According to the proposed amendment, a broker-dealer must deduct, with regard to fidelity bonding requirements prescribed by a broker-dealer's examining authority, the excess of any deductible amount over the maximum deductible amount permitted by that authority.

Broker-Dealer Solvency Requirement

.57 Under the proposed amendment, a broker-dealer would be required to cease its securities business activities if it is insolvent. *Insolvent* would be defined as, among other things, a broker-dealer's placement in a voluntary or involuntary bankruptcy or similar proceeding; the appointment of a trustee, receiver, or similar official; a general assignment by the broker-dealer for the benefit of its creditors; an admission of insolvency; or the inability to make computations necessary to establish compliance with the Net Capital Rule. In addition, a proposed amendment would require a broker-dealer meeting the definition of *insolvent* to provide immediate notice to the SEC, the broker-dealer's DEA and, if applicable, the CFTC.

Amendment to Rule Governing Orders Restricting Withdrawal of Capital From a Broker-Dealer

.58 Currently Rule 15c3-1(e) provides that broker-dealers must notify the SEC upon certain withdrawals of capital. The SEC may also issue an order temporarily restricting a broker-dealer from withdrawing capital or making loans or advances to certain parties under certain circumstances. One of the circumstances is when withdrawals, advances, or loans (when aggregated with all other withdrawals, advances, or loans on a net basis during a 30 calendar-day period) exceed 30 percent of the firm's excess net capital. Due to the difficulty of calculating whether the 30 percent of excess net capital threshold has been met, the SEC proposes to remove the 30 percent of excess net capital limitation. All other conditions in Rule 15c3-1(e) would remain unchanged.

Amendment to Appendix A of Rule 15c3-1

.59 The SEC previously adopted a temporary amendment which permits broker-dealers to employ theoretical option pricing models to calculate haircuts

for listed options and related hedge positions. The SEC now proposes to make this temporary amendment permanent.

Money Market Funds

.60 The haircut of 2 percent that broker-dealers must apply under Rule 15c3-1 for money market funds would be reduced to 1 percent under the SEC proposal.

Technical Amendments to the Financial Responsibility Rules

.61 A number of technical amendments are proposed to remove superfluous or redundant text.

Regulatory Update—SEC

.62 In addition to reading the following SEC regulatory matters, readers should also visit the SEC Web site at www.sec.gov to keep informed about recent SEC rulemaking activities and for further information.

Final Rules to Implement the Bank Broker Provisions of the Gramm-Leach-Bliley Act (SEC Releases 34-56501 and 34-56502)

.63 The SEC and the Board of Governors of the Federal Reserve System announced the adoption of final joint rules to implement the bank broker provisions (and related rules and rule amendments) of the Gramm-Leach-Bliley (GLB) Act. This will essentially allow customers to obtain a wide variety of financial products through their bank. The rules define the scope of securities activities that a bank may conduct without registering with the SEC as a securities broker and implement the most important *broker* exceptions for banks adopted by the GLB Act. The rules implement the statutory exceptions that allow a bank (subject to certain conditions) to continue to conduct securities transactions for its customers as part of the bank's functions and to refer customers to a securities broker-dealer pursuant to a networking arrangement with the broker-dealer. These rules are designed to accommodate the business practices of banks and to protect investors. Banks are exempt from complying with the rules until the first day of their first fiscal year that commences after September 30, 2008.

Adoption of Updated EDGAR Filer Manual (SEC Release 33-8834—see release for list of other applicable releases)

.64 The Electronic Data Gathering, Analysis, and Retrieval System (EDGAR) Filer Manual was updated to incorporate a number of changes in the rules and in the function of the system. Effective date is August 20, 2007.

Regulation SHO and Rule 10a-1 and amendments (SEC Releases 34-55970 and 34-56212)

.65 The SEC amended the short sale price test under the Exchange Act to remove restrictions on the execution prices of short sales (price tests) and prohibit any SRO from having a price test. Regulation SHO was also amended to remove the requirement that a broker-dealer mark a sell order of an equity security as *short exempt* if the seller is relying on an exception from a price test. The second amendment eliminates the grandfather provision of Regulation SHO, amends the close-out requirement of Regulation SHO for certain securities that

a seller is *deemed to own*, and updates the market decline limitation referenced in the regulation. Effective dates are July 3, 2007, and October 15, 2007.

Technical Amendments to Form BD and Form BDW (SEC Release 34-55643)

.66 The uniform broker-dealer registration form and the uniform request for withdrawal from broker-dealer registration have been updated. Effective date is April 23, 2007.

Revisions to Non-Public Broker-Dealer Financial Statement Requirements (SEC Release 34-54920)

.67 Broker-dealers who are not issuers may file with the SEC a balance sheet and income statement and may send to their customers a balance sheet certified by an independent public accountant instead of by a Public Company Accounting Oversight Board (PCAOB) registered public accounting firm for fiscal years ending before January 1, 2009. A 2005 extension was set to expire on January 1, 2007, but was extended for 2 additional years.

Interagency Statement on Sound Practices Concerning Elevated Risk Complex Structured Finance Activities

.68 The Office of the Comptroller of the Currency, the Office of Thrift Supervision, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the SEC have issued a statement related to complex structured finance transactions (CSFT). The use of this type of product is considered to be an essential part of capital markets, and there is a broad array of products with varying levels of complexity. Therefore the agencies have issued this statement to describe the types of risk management principles that they believe may help a financial institution to identify CSFTs that may pose heightened legal or other risks to the institution and to evaluate, manage, and address those risks within the entity's internal control framework. A copy of this interagency statement can be found online at www.sec.gov/rules/policy/2007/34-55043.pdf.

Internal Control Over Financial Reporting Developments

.69 The SEC has finalized several rules related to its required report on internal control over financial reporting. More information regarding SEC developments can be found in the *SEC and PCAOB Alert—2007/08* (product no. 022498kk). See also the SEC Web site at www.sec.gov for complete information.

Definition of a Significant Deficiency

.70 On August 3, 2007, the SEC posted a final rule whereby it defined the term *significant deficiency* for purpose of implementing Section 302 and Section 404 of the Sarbanes-Oxley Act of 2002. The term is defined as "a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those responsible for oversight of the registrant's financial reporting." The full text of this rule can be found online at www.sec.gov/rules/final/2007/33-8829.pdf. This definition of significant deficiency applies to issuers and auditors of issuers. Auditors of nonissuers must use the SAS No. 112 definition in AU section 325, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA Professional Standards, vol. 1).

Commission Guidance Regarding Management's Report on Internal Control Over Financial Reporting Under Section 13(a) or 15(d) of the Securities Exchange Act of 1934

.71 The SEC posted Interpretive Release No. 33-8810 and No. 34-55929 on June 20, 2007, to provide guidance for management regarding its evaluation and assessment of internal control over financial reporting. This guidance is organized around two broad principles. The first principle is that management should evaluate whether it has implemented controls that adequately address the risk that a material misstatement of the financial statements would not be prevented or detected in a timely manner. The guidance describes a top-down, risk-based approach to this principle. The second principle is that management's evaluation of evidence about the operation of its controls should be based on its assessment of risk. The guidance provides an approach for making risk-based judgments about the evidence needed for the evaluation. More specifically, this interpretive guidance:

- Explains how to vary evaluation approaches for gathering evidence based on risk assessments.
- Explains the use of "daily interaction," self-assessment, and other ongoing monitoring activities as evidence in the evaluation.
- Explains the purpose of documentation and how management has flexibility in documenting support for its assessment.
- Provides management significant flexibility in making judgments regarding what constitutes adequate evidence in low-risk areas.
- Allows for management and the auditor to have different testing approaches.

.72 The text of the full interpretation can be found online at www.sec.gov/rules/interp/2007/33-8810.pdf.

Amendments to Rules Regarding Management's Report on Internal Control Over Financial Reporting

.73 On June 20, 2007, the SEC posted an amendment to its rules to clarify several issues related to management's Report on Internal Control over Financial Reporting. One clarification is that an evaluation of internal control over financial reporting that complies with the SEC's interpretive guidance published in Release No. 34-55929 is one way to satisfy the requirement for management to evaluate the effectiveness of the issuer's internal control over financial reporting. However, the use of this guidance is voluntary. The SEC has also amended its rules to define the term *material weakness* as "a deficiency or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of the registrant's annual or interim financial statements will not be prevented or detected on a timely basis." Lastly, the SEC clarified that an auditor is required to express a single opinion directly on the effectiveness of internal control over financial reporting in its attestation report on internal control over financial reporting (the auditor does not have to report on management's assessment of internal control over financial reporting). The amendments are intended to facilitate more effective and efficient evaluations of internal control over financial reporting by management and auditors. Access www.sec.gov/rules/final/2007/33-8809.pdf for the entire release.

Regulatory Update—CFTC

.74 The following summarizes certain amendments to regulations and interpretations of the CFTC and other regulatory guidance issued or that became effective in the latter part of 2006 and in 2007. The amendments affected the financial reporting requirements of registered FCMs, and also of IBs that are not guaranteed by FCMs. The amendments were published in the Federal Register, and they and the other items discussed in the following paragraphs can be accessed electronically at the CFTC Web site at www.cftc.gov.

Amendment to Regulation 3.10 to Require Certain Registrants to Conduct Annual Review of Registration Information

.75 Effective August 1, 2007, the CFTC amended Regulation 3.10 to require each registered FCM, IB, commodity trading advisor, commodity pool operator (CPO), and leverage transaction merchant to conduct an online annual review of the firm's registration information maintained by the National Futures Association (NFA). The amendment is intended to enhance the accuracy of the registration information maintained in the NFA's registration database. The CFTC also adopted a technical and conforming amendment to CFTC Regulation 3.33(f).

CFTC Staff and FinCEN Issue Guidance on Application of CIP Rules to Give-Up Arrangements

.76 In April 2007, the staffs of the CFTC and the FinCEN jointly issued guidance on the application of the customer identification program (CIP) regulation to give-up arrangements in the futures industry. The guidance is in response to a request from the Futures Industry Association, a futures industry trade association, about whether FCMs acting solely as executing brokers in give-up arrangements are required to comply with CIP requirements.

.77 The guidance clarifies the CIP regulation for FCMs that was issued in 2003 by stating that clearing brokers in give-up arrangements are required to comply with CIP requirements because they establish a formal relationship with a futures and options customer when they open an account. The guidance explains that, subject to a limited exception, executing brokers, who in a give-up arrangement facilitate trades, do not establish a formal relationship requiring them to apply their CIPs to such futures and options customers.

.78 The guidance also reminds FCMs that they must have an AML program that contains risk-based policies, procedures, and controls for assessing money laundering risk posed by all of its operations, including its execution brokerage activities; for monitoring and mitigating that risk; and for detecting and reporting suspicious activity.

CFTC Adopts Rule Requiring FCMs to Become Members of a Registered Futures Association

.79 Effective February 21, 2007, the CFTC adopted an amendment to Regulation 170.15(a) that requires a person that is registered as an FCM, regardless of whether he or she is required to be so registered, to become members of a registered futures association (RFA). The action will further the goals of industry self-regulation and CFTC oversight, a cornerstone of the Commodity Futures Modernization Act of 2000, by ensuring that an RFA, and not the CFTC, will be responsible for monitoring the activities of FCMs in the first instance.

Regulatory Update—Self-Regulatory Organizations

.80 Under the Exchange Act, all broker-dealers are required to be members of an SRO such as FINRA, or some other organization that is designated to perform routine surveillance and monitoring of its members. Likewise, CFTC regulations require FCMs to designate a self-regulatory organization (DSRO). During the past year, a number of significant regulations were issued by SROs and DSROs, some of which are described in the following sections. Please refer to the Web sites of the respective SROs and DSROs for a complete listing of recently issued rules and regulations.

.81 On July 31, 2007, the consolidation of the NASD and the member regulation, enforcement, and arbitration operations of the NYSE became effective. The consolidated entity has been named the FINRA. Please see the section titled "NASD and NYSE Regulation Combine Operations" earlier in this alert for more information. To date, the rules of these two organizations have not yet been merged together. Therefore, we will list new regulatory developments separately for the NASD and the NYSE in this year's alert.

NASD Rulemaking

Notice to Members 06-23—NASD Reminds FINOPs of their Obligations under NASD Rule 1022 and Issues Guidance to FINOPs Who Work Part-Time, Work Off-Site, or Hold Multiple Registrations

.82 NASD issued this notice to members to remind member firms and registered financial and operations principals (FINOPs) of a FINOP's duties and responsibilities under Rule 1022 (Categories of Principal Registration). These duties are applicable to all FINOPs, regardless of whether they are employed full-time or part-time, perform such duties on-site or off-site of the member firm, or hold registrations with more than one firm. This notice also provides additional guidance to assist FINOPs who are employed part-time, operate off-site, or hold multiple registrations in fulfilling their duties. Additionally, NASD reminds members and FINOPs that their failure to meet their responsibilities can result in disciplinary actions against both the FINOP and the member firm employing the FINOP.

Notice to Members 06-48—SEC approves Amendments to NASD Rules 2210 and 2211 to Require Disclosure of Fees and Expenses in Mutual Fund Performance Sales Material; Effective Date: April 1, 2007

.83 This notice sets forth the disclosure and presentation requirements on certain member communications with the public that presents non-money market mutual fund performance data. Such communication must disclose the standardized performance information mandated by Rule 482 under the Securities Act of 1933 and, to the extent applicable, the fund's maximum front-end or back-end sales charge and annual operating expense ratio. The rule states that the required information is to be presented prominently, and in any print advertisement, in a prominent text box.

Notice to Members 07-16—Frequently Asked NASD Financial and Operational Questions

.84 This notice provides member firms with answers to many frequently asked questions.

Notice to Members 07-32—NASD Amends Rule 3013 and Interpretive Material 3013 to Permit Members to Designate Co-Chief Executive Officers and Multiple Chief Compliance Officers

.85 Beginning July 16, 2007, the compliance date, NASD member firms may designate co-chief executive officers and multiple chief compliance officers to discharge the requirements of Rule 3013 (Annual Certification of Compliance and Supervisory Processes).

Notice to Members 07-45—Amendments to NASD Rule 3210 to Conform with Amendments to the SEC's Regulation SHO Delivery Requirements

.86 Beginning on the effective date, October 15, 2007, firms are required to close out within 35 consecutive settlement days any previously "grand-fathered" fail-to-deliver positions in a nonreporting threshold that is on the Rule 3210 threshold list on that date. New fails in a nonreporting threshold security after October 15, 2007, will be subject to a 13 consecutive settlement day close-out requirement. Please see the notice for information regarding an exception to this rule for closing out fails to deliver resulting from sales of nonreporting threshold securities pursuant to SEC Rule 144. The rules are available at the Rules and Regulations tab at the FINRA Web site at www.finra.org.

NYSE Rulemaking

Information Memo 06-80, Permitting DVP/RVP Customers to Opt Out of Receiving Statements, Issued November 30, 2006

.87 The SEC has approved amendments to NYSE Rule 409, "Statements of Accounts to Customers," permitting institutional customers doing business solely on a deliver versus payment/receive versus payment basis (DVP/RVP) to opt out of receiving statements as otherwise required by the rule, subject to prescribed requirements.

Information Memo 06-87, SIPC Information for Customers, Issued December 22, 2006

.88 The SEC has approved amendments to NYSE Rule 409, "Statements of Accounts to Customers" requiring member organizations to add a legend to customer statements of account advising customers to report promptly any inaccuracy or discrepancy in that person's account to his or her brokerage firm, and a new Rule 409A requiring that member organizations advise customers, in writing, of the availability of information regarding the Securities Investor Protection Corporation (SIPC). The SEC recently approved comparable amendments to NASD Rule 2340, "Customer Account Statements."

Information Memo 07-37, Amendments to NYSE Net Capital Rules, Issued April 25, 2007

.89 The SEC approved amendments to NYSE Rules 325 and Rule 326 to reflect CFTC amendments under the Exchange Act, including amendments to Exchange Act Rule 15c3-1, which established an alternative method of computing net capital for broker-dealers. The NYSE amendments also reflect amendments to CFTC rules under the Commodities Exchange Act with respect to minimum net capital requirements for FCMs.

Information Memo 07-76, *SEC and NYSE Amendments Concerning Short Sale Rules*, Issued July 23, 2007

.90 The SEC issued a release adopting amendments to its rules governing short sales. Specifically, the SEC amendments eliminate Rule 10a-1 under the Exchange Act. Additionally, the amendments add Rule 201 of Regulation SHO to provide that no price test, including any price test by any SRO, shall apply to short selling in any security. Rule 200(g) of Regulation SHO, as amended, removes the requirement that a broker-dealer mark a sell order of an equity security as *short exempt* if the seller is relying on an exception from Rule 10a-1, or any price test of any exchange or national securities association as this rule is no longer necessary with the elimination of the price test requirements.

Information Memo 07-79, *Changes to Disciplinary Proceedings at NYSE Regulation as a Result of the Regulatory Consolidation with NASD*, Issued July 30, 2007

.91 The purpose of this information memo is to advise members and member organizations of changes to disciplinary procedures at NYSE regulation that will be implemented in connection with the regulatory consolidation of NASD and certain member firm functions from NYSE regulation.

National Futures Association

.92 The NFA amended several of its rules governing Forex Dealer Members (FDMs). These amended requirements include the following:

- Effective March 31, 2007, the NFA replaced an FDM capital requirement calculation that had been based on 1 percent of the total net notional value of retail customer positions with a new capital requirement calculation based on 5 percent of liabilities to retail off-exchange foreign currency (forex) customers.
- Effective July 1, 2007, FDMs must calculate the amount owed to U.S. customers for forex transactions and hold assets equal to or in excess of that amount at a qualifying institution in the United States or in a money center country (as defined in CFTC Regulation 1.49).
- Effective December 21, 2007, the minimum net capital requirement for FDMs will increase from \$1 million to \$5 million. Other NFA amendments effective on December 21, 2007, will eliminate concentration charges for FDMs and will be replaced by restrictions on the types of firms with which an FDM may maintain assets and cover its exposure for purposes of the haircuts specified in CFTC Regulation 1.17.

Recent Concerns of Regulators

.93 Over the past several years during examinations of broker-dealers and FCMs, regulators encountered a number of issues, some of which are discussed in the following paragraphs.

SEC Compliance Alert

.94 The SEC released a compliance alert in June 2007 that identifies areas that have been of concern during recent compliance examinations. Listed in the following paragraphs in summary form are compliance issues found in

broker-dealer firms. Also included in the compliance alert are issues found at investment advisers. Readers can view the full text of the compliance alert for complete information by accessing www.sec.gov/about/offices/ocie/complialert.htm.

Sales of Section 529 College Savings Plans

.95 Many firms appeared to lack adequate written supervisory procedures or supervisory processes to review the 529 plan transactions in customer accounts. Also, it did not appear that the firms had incorporated training for registered representatives or supervisors with respect to the specific factors that could impact the suitability of the firm's recommendations with respect to 529 plans.

Sales of Collateralized Mortgage Obligations

.96 Examiners found deficiencies in the disclosures provided to customers in connection with Collateralized Mortgage Obligation (CMO) transactions. These deficiencies were in both content and type of materials provided to customers. They also found a lack of supervisory procedures to review the adequacy of disclosures made to investors in connection with the sale of CMOs, indications that CMOs were sold to unsuitable customers, and some instances of undisclosed markups that appeared to be excessive.

Sales of Real Estate Investment Trusts

.97 Inadequate and potentially misleading disclosures to investors were found concerning the risk of the investments, the possible future public trading market for the real estate investment trusts (REITs), and their liquidity. Deficiencies were also noted relating to the valuation of the investments in REITs, the source of dividend payments, sales of the securities prior to registration, lack of supervision over registered representatives selling REITs, and potential conflicts of interest arising from excessive noncash compensation paid by sponsors of the REIT.

Supervisory Procedures to Ensure Compliance with Regulation SHO

.98 Many firms were found to have inadequate written supervisory procedures to ensure compliance with regulation SHO. Consequently, the firms were not in compliance with various requirements.

Charges in Separately Managed Accounts

.99 Examinations found instances where customers had been overcharged for separately managed account fees. It appeared that control procedures were lacking to ensure that the fees assessed to customers were consistent with the charges outlined in customer agreements and offering documents.

Part-Time Financial and Operations Principles

.100 During examinations of broker-dealers employing a part-time FINOP, examiners found that some firms appeared to have inaccurate books and records that resulted in erroneous financial reports to regulators. Instances were found where the part-time FINOP had no role in the actual supervision or creation and maintenance of various books and records, as required by NASD.

Expense Sharing Arrangements

.101 Targeted examinations of broker-dealers that utilized expense sharing arrangements revealed various deficiencies, including indications that

certain firms operated while failing to maintain the required minimum net capital. The deficiencies were caused by the inappropriate shifting of a liability from the broker-dealer to an affiliate. Also, some firms failed to maintain adequate expense-sharing agreements.

CFTC Concerns

Letters of Credit

.102 Although exchange or clearinghouse rules may permit letters of credit to be accepted as performance bond or margin, letters of credit cannot be used to offset or secure any FCM customer deficit. The risk of improperly including letters of credit in regulatory reporting may be increased by the use of back office applications that are provided by third party service providers. All FCMs are reminded that:

- Letters of credit are not to be reported as segregated assets under CFTC Regulation 1.20 or as set-aside assets under Part 30 of the regulations of the CFTC. When computing the amount of customer funds required to be held in segregated or secured accounts, letters of credit must be excluded and cannot be used to offset any customer deficit.
- Letters of credit are not satisfactory collateral under CFTC Regulation 1.17 for securing any form of receivable owed to the FCM, including a receivable arising from a deficit in the account of a customer or noncustomer.

Maintenance of Minimum Financial Requirements and Notification Requirements

.103 CFTC Regulation 1.17 specifies minimum capital requirements, and CFTC Regulation 1.12 specifies the conditions requiring FCMs to give notice of certain events occurring in a firm's financial or operational condition, changes or anticipated changes in capital balances, and how and when such notices are to be given.

.104 For example, Regulation 1.12(g) requires that an FCM provide written notice of a substantial reduction in capital as compared to that last reported in a financial report filed with the CFTC pursuant to Regulation 1.10. If such reduction would be caused by a withdrawal of equity capital of 30 percent or more, notice must be provided at least 2 days prior to the withdrawal. For any reduction in net capital of 20 percent or more, notice must be provided within 2 days after the reduction.

.105 FCMs should establish procedures to ensure that the notices required by CFTC regulations are filed with the CFTC within the established time frames set forth in the regulations. In particular, it is a violation of CFTC rules for an FCM to not file a notice of a withdrawal of equity capital of 30 percent or more at least 2 days prior to such withdrawal. FCMs should not provide the notice after the filing of the financial statements in which the withdrawal is reflected. Failure to make a timely filing negates the purpose of the rule, which is designed to alert the CFTC to a possible change in an FCM's financial condition. Notices should be filed promptly when due and provide an explanation for the decrease in net capital.

.106 FCMs also should consider including details in the comments section of the electronically filed financial report affected by reporting when they have made or intend to make the filing required by Regulation 1.12(g).

Segregation of Customer Funds in Multiple Currencies

.107 FCMs must maintain compliance with CFTC recordkeeping, computation, and segregation requirements applicable to customer funds held in multiple currencies. Regulation 1.20 requires that all customer funds be separately accounted for and segregated as belonging to commodity customers and deposited in an account that clearly identifies those funds as such. Regulation 1.32 requires each FCM to compute as of the close of each business day, on a currency-by-currency basis:

1. The total amount of customer funds on deposit in segregated accounts on behalf of commodity and commodity option customers;
2. The amount of such customer funds required to be on deposit in segregated accounts; and
3. The amount of the FCM's residual interest in such customer funds.

.108 CFTC Regulation 1.49 specifies the conditions under which the FCM's obligations to a customer may be denominated in currencies other than the U.S. dollar. The regulation also specifies the geographic locations in which customer funds may be held and the required qualifications for permissible depositories in those locations.

.109 Some areas of recent focus in regard to these regulations include the treatment of customer-owned securities that are denominated in non-U.S. currencies, and which are held in depositories outside of the United States. All FCMs should take steps to ensure that such depositories satisfy all of the required criteria set forth in Regulation 1.49(d)(3). FCMs should also ensure that such customer owned securities are included in the segregation computation for the currency in which they are denominated.

.110 Furthermore, FCMs should ensure that offsets to customer account deficits that are denominated in multiple currencies are computed in accordance with Rule 1.49(e). At the close of each business day, Rule 1.49(e) requires the FCM to maintain in segregated accounts sufficient U.S. dollars, held in the United States, to meet all U.S. dollar obligations, and also sufficient funds in each other currency to meet obligations in such currency, with certain permitted substitutions:

1. U.S. dollars held in the United States may be used to meet obligations denominated in any other currency.
2. "Money center" currencies and U.S. dollars held in money center countries may be held to meet obligations denominated in currencies other than the U.S. dollar.

Foreign Currency Exchange Transactions (Forex)

.111 CFTC staff issued an advisory on August 30, 2007, concerning retail off-exchange foreign currency (forex) futures or option transactions.

.112 The advisory addresses the following issues: (1) registration requirements for associated persons of firms registered as IBs, commodity trading advisors, and CPOs that are involved in forex transactions; (2) the permissibility of certain unregistered affiliates of an FCM to act as proper counterparties

in forex transactions; (3) claims that forex customer funds are segregated; (4) introducing entities acting as FCMs; (5) the applicability of the IB guarantee agreement to forex transactions and prohibiting guaranteed IBs from introducing forex transactions to an FCM that is not its guarantor FCM; (6) prohibiting forex account statements of an FCM's unregistered affiliate from being included in the FCM's account statements to its customers; and (7) prohibiting retail customers from acting as counterparties to each other in forex transactions.

.113 In addition, on May 7, 2007, the CFTC and the North American Securities Administrators Association issued a joint investor alert to warn of the dangers facing retail investors who are lured into forex trading frauds.

.114 The regulators cautioned investors that off-exchange forex trading by retail investors is at best extremely risky, and at worst, plagued by outright fraud.

CFTC Annual "Dear CPO" Letter

.115 On January 31, 2007, CFTC staff issued its annual letter to CPOs outlining key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter emphasized the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

.116 The following are major concerns addressed in the letter:

- Due dates of commodity pool financial filings—late filings
- Other filings by CPOs regarding:
 - Replacement of an accountant, election of fiscal year, and
 - Regulation 4.13 exemptions
- Compliance with U.S. generally accepted accounting principles (GAAP)
- Requests for limited relief from U.S. GAAP compliance for certain offshore commodity pools
- Initial annual reports and final annual reports
- Accounting developments:
 - Financial Accounting Standards Board (FASB) Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*, implementation and its impact on participants' redemptions
 - Alternative investments, audit considerations
 - AICPA technical guidance regarding offering costs
 - FASB Statement No. 157, *Fair Value Measurements*
- Requests for confidential treatment of commodity pool annual reports

.117 The letter also noted that the CFTC's Division of Clearing and Intermediary Oversight issued similar letters in prior years, which are available on

the CFTC's Web site at www.cftc.gov. Those letters should be consulted with respect to commodity pool annual financial statements and reporting. In addition, CFTC interpretations and staff letters providing guidance from 1995 forward are also available there. In particular, CFTC Interpretive Letter 94-3, "Special Allocations of Investment Partnership Equity," addresses how a CPO should report such allocations to the general partner in a commodity pool's financial statements.

CFTC "Dear FCM" Letter

.118 On February 8, 2007, CFTC staff issued a letter to FCMs outlining key reporting issues and common reporting deficiencies found in annual audited financial reports for FCMs. The letter emphasized the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of FCMs. CFTC staff suggested that FCMs share the letter with their independent auditors.

.119 Issues addressed in the letter include the following:

- Filing deadline: CFTC Regulation 1.10(b)(1)(ii)
- Accountant's report on material inadequacies: CFTC Regulation 1.16(c)(5)
- Paper versus electronic filing: CFTC Regulation 1.10(b)(2)(iii)
- Reporting material differences between unaudited and audited financial reports: CFTC Regulation 1.10(d)(2)(vi)
- Exchange memberships excluded from current assets: CFTC Regulation 1.17(c)(2)(x)
- Required oath or affirmation: CFTC Regulation 1.10(d)(4)
- Replacement of Accountants: CFTC Regulation 1.16(g)

.120 The letter is available on the CFTC's Web site at www.cftc.gov.

Audit and Attestation Issues and Developments

.121 Authoritative audit guidance issued during the past year that affects a wide variety of entities can be found in this alert in the section titled "Recent Auditing and Attestation Pronouncements and Related Guidance." Guidance issued this year that is of specific interest to the securities industry can be found in the following paragraphs. The following summary is for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable rule or release.

AICPA Practice Aid, Alternative Investments—Audit Considerations

.122 Over the past several years, many companies have dramatically increased their investment in financial instruments that do not have a readily determinable market value (that is, investments not listed on national exchanges or on over-the-counter markets, or for which quoted market prices are not available from sources such as financial publications, the exchanges, or the NASDAQ System). This practice aid addresses challenges associated with auditing such investments. These investments include private investment funds meeting the definition of an investment company under the provisions of the AICPA Audit

and Accounting Guide *Investment Companies*, such as hedge funds, private equity funds, real estate funds, venture capital funds, commodity pools, offshore fund vehicles, and funds of funds, as well as bank common/collective trust funds. Collectively, these types of investment funds are commonly referred to as alternative investments. Alternative investments may be structured as limited partnerships, limited liability corporations, trusts, or corporations.

.123 This practice aid was developed to provide additional guidance to auditors of investor entities as to how the auditor may obtain sufficient appropriate audit evidence in order to conclude that the financial statements are free of material misstatement. This nonauthoritative practice aid will assist auditors in auditing alternative investments. The practice aid includes guidance on the following:

- General considerations pertaining to auditing alternative investments
- Addressing management's financial statement existence assertion
- Addressing management's financial statement valuation assertion
- Management representations
- Disclosure of certain significant risks and uncertainties
- Reporting

.124 The practice aid also includes the following appendixes:

- Appendix 1, "Example Confirmation for Alternative Investments"
- Appendix 2, "Illustrative Examples of Due Diligence, Ongoing Monitoring, and Financial Reporting Control"

.125 You can download the practice aid at www.aicpa.org/download/members/div/auditstd/Alternative_Investments_Practice_Aid.pdf.

Accounting Issues and Developments

.126 Authoritative guidance issued in the past year that affects a wide range of entities is located in the section titled "Recent Accounting Pronouncements and Related Guidance," found in this alert. Guidance that is of special interest to the securities industry can be found below. While some of this guidance was issued in 2006, its full effect is now being felt. Therefore, it is being included again in this year's alert.

Fair Value Measurements

FASB Statement No. 157

.127 On September 15, 2006, the FASB issued FASB Statement No. 157 which provides enhanced guidance for using fair value to measure assets and liabilities. FASB Statement No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value and does not expand the use of fair value in any new circumstances. The following is a brief discussion of some of the provisions of FASB Statement No. 157 that should be of interest to broker-dealers and their auditors.

.128 FASB Statement No. 157 clarifies that the exchange price is the price in an orderly transaction between market participants to sell the asset or

transfer the liability in the market in which the reporting entity would transact for the asset or liability, that is, the principal or most advantageous market for the asset or liability. The transaction to sell the asset or transfer the liability is a hypothetical transaction at the measurement date, considered from the perspective of a market participant that holds the asset or owes the liability. Therefore, the definition focuses on the price that would be received to sell the asset or paid to transfer the liability (an exit price), not the price that would be paid to acquire the asset or received to assume the liability (an entry price).

.129 FASB Statement No. 157 establishes the fair value hierarchy, which prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. Unobservable inputs should be used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date.

.130 Among other matters, FASB Statement No. 157 precludes the use of a blockage factor. Paragraph 27 of FASB Statement No. 157 provides that:

"If the reporting entity holds a position in a single financial instrument (including a block) and the instrument is traded in an active market, the fair value of the position shall be measured within Level 1 as the product of the quoted price for the individual instrument times the quantity held. The quoted price shall not be adjusted because of the size of the position relative to trading volume (blockage factor). The use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price."

.131 Footnote 11 to this paragraph states that, "The guidance in this Statement applies for positions in financial instruments (including blocks) held by all entities, including broker-dealers and investment companies within the scope of the AICPA Audit and Accounting Guides for those industries."

.132 The guidance in FASB Statement No. 157 applies for derivatives and other financial instruments measured at fair value under FASB Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities*, at initial recognition and in all subsequent periods. Therefore, FASB Statement No. 157 nullifies the guidance in footnote 3 of Emerging Issues Task Force (EITF) Issue No. 02-3, "Issues Involved in Accounting for Derivative Contracts Held for Trading Purposes and Contracts Involved in Energy Trading and Risk Management Activities," which applied for derivatives (and other) instruments measured at fair value at initial recognition under FASB Statement No. 133. That guidance precluded immediate recognition in earnings of an unrealized gain or loss, measured as the difference between the transaction price and the fair value of the instrument at initial recognition, if the fair value of the instrument was determined using significant unobservable inputs. FASB Statement No. 157 provides, however, that for unobservable inputs, the fair value measurement objective remains the same, that is, an exit price from the perspective of a market participant that holds the asset or owes the liability. Consistent with that objective, FASB Statement No. 157 clarifies that the fair

value measurements should be adjusted for risk, that is, the amount market participants would demand because of the risk (uncertainty) inherent in a particular valuation technique used to measure fair value (such as a pricing model) or the risk inherent in the inputs to the valuation technique (a risk premium notion), or both. Accordingly, a measurement (for example, a "mark-to-model" measurement) that does not include an adjustment for risk would not represent a fair value measurement if market participants would include one in pricing the related asset or liability.

.133 FASB Statement No. 157 also amends FASB Statement No. 133 to remove the similar guidance to that in EITF Issue No. 02-3, which was added by FASB Statement No. 155, *Accounting for Certain Hybrid Financial Instruments*.

.134 FASB Statement No. 157 provides that if an input used to measure fair value is based on bid and ask prices (for example, in a dealer market), the price within the bid-ask spread that is most representative of fair value in the circumstances should be used to measure fair value, regardless of where in the fair value hierarchy the input falls (Level 1, 2, or 3). FASB Statement No. 157 does not preclude the use of mid-market pricing or other pricing conventions as a practical expedient for fair value measurements within a bid-ask spread.

.135 FASB Statement No. 157 clarifies that market participant assumptions also include assumptions about the effect of a restriction on the sale or use of an asset. It provides that a fair value measurement for a restricted asset should consider the effect of the restriction if market participants would consider the effect of the restriction in pricing the asset.

.136 FASB Statement No. 157 also clarifies that a fair value measurement for a liability reflects its nonperformance risk (the risk that the obligation will not be fulfilled). Because nonperformance risk includes the reporting entity's credit risk, the reporting entity should consider the effect of its credit risk (credit standing) on the fair value of the liability in all periods in which the liability is measured at fair value under other accounting pronouncements, including FASB Statement No. 133.

.137 FASB Statement No. 157 also expands disclosures about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. The disclosures focus on the inputs used to measure fair value and for recurring fair value measurements using significant unobservable inputs (within Level 3 of the fair value hierarchy), the effect of the measurements on earnings (or changes in net assets) for the period. FASB Statement No. 157 encourages entities to combine the fair value information disclosed under FASB Statement No. 157 with the fair value information disclosed under other accounting pronouncements, including FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, where practicable.

.138 FASB Statement No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007,² and interim periods within those fiscal years. Earlier application is encouraged, provided that the reporting entity has not yet issued financial statements for that fiscal year, including

² FASB is proposing a 1 year deferral for the implementation of FASB Statement No. 157 for certain nonfinancial assets and liabilities. This delay is not yet approved and readers should be alert for further developments.

financial statements for an interim period within that fiscal year. You can access FASB Statement No. 157 online at www.fasb.org/pdf/fas157.pdf.

Fair Value Measurement—Practical Guidance

.139 As companies implement the fair value guidance, they may encounter unanticipated issues. One of these issues has arisen due to the current conditions in the credit markets. The AICPA Center for Audit Quality (CAQ) issued a White Paper on FASB Statement No. 157 entitled "Measurements of Fair Value in Illiquid (or Less Liquid) Markets" in October 2007. The purpose of the white paper is to discuss issues associated with the measurement of fair value under existing GAAP in the context of illiquid (or less liquid) market conditions that currently exist in many segments of the credit markets. The paper can be accessed online at www.thecaq.org/members/alerts/CAQAlert2007_51_10032007.pdf.

FASB Statement No. 159

.140 Subsequent to the issuance of FASB Statement No. 157, the FASB issued FASB Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115*. This statement is expected to expand the use of fair value measurement, which is consistent with the FASB's long-term measurement objectives for accounting for financial instruments. FASB Statement No. 159 allows entities to choose to measure many financial instruments and certain other items at fair value. The standard permits an entity to elect the fair value option on an instrument-by-instrument basis; and once the election is made, it is irrevocable. This statement's objective is to improve financial reporting by providing entities with an opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. In addition, FASB Statement No. 159 establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. The statement does not eliminate disclosure requirements included in other accounting standards, such as the requirements for disclosures about fair value measurements included in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, and FASB Statement No. 157.

.141 FASB Statement No. 159 is effective as of the beginning of an entity's first fiscal year that begins after November 15, 2007. Early adoption is permitted as long as the entity also elects to apply the provisions of FASB Statement No. 157 and has not yet issued financial statement, including required notes to those financial statements, for any interim period for the fiscal year of adoption. The choice to adopt early should be made within 120 days of the beginning of the fiscal year of adoption (for calendar year end entities, by April 2007). The FASB and SEC have expressed concern in the way some early adopters have applied the transition provisions of the standard. The AICPA CAQ issued an alert on this development in April, 2007. The alert advises auditors to exercise appropriate professional skepticism when evaluating if a principles-based standard such as this is applied in a good faith manner consistent with those objectives and principles. Specifically the alert warns auditors to "be alert for circumstances in which an entity proposes to adopt FASB Statement No. 159 in a manner that is contrary to the principles and objectives outlined in the standard." The alert can be accessed online at www.

thecaq.org/newsroom/pdfs/CAQPressRelease_041807a.pdf. Readers can access the full text of FASB Statement No. 159 on the FASB Web site at www.fasb.org.

FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*

.142 In June 2006, the FASB issued FASB Interpretation No. (FIN) 48, *Accounting for Uncertainty in Income Taxes—an Interpretation of FASB Statement No. 109*. FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. The standard also provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure, and transition.

.143 FIN 48 was issued to reduce the significant diversity in practice. A company's tax positions can change over time from a myriad of variables, for example, IRS developments, state taxing authorities, or tax court cases. Companies were recording uncertainties in different ways. Some companies had been assessing a position being supported under a tax audit, some had also included the probability of an audit, and some companies simply recorded tax assets and liabilities based on what was filed on their returns. Additionally, some companies recorded tax reserves for contingent tax liabilities.

.144 The scope of FIN 48 applies to all tax positions. The interpretation assumes that a company cannot factor in the probability of being audited. Therefore, for purposes of determining the likelihood of being sustained, the taxpayer has to presume the position will be examined by taxing authorities. Consequently, the tax benefit of a position that would not be sustained under audit cannot be recorded.

.145 Prior to the issuance of FIN 48, management's common approach was to create an inventory of uncertain tax positions and evaluate them under FASB Statement No. 5, *Accounting for Contingencies*. Because FIN 48 now provides guidance, FASB Statement No. 5 no longer applies to uncertain tax positions. However, for clarification, FIN 48 does not in any way alter the requirement in FASB Statement No. 109, *Accounting for Income Taxes*, to assess the need for a valuation allowance for deferred tax assets.

.146 Only tax positions that meet the more likely than not recognition threshold, as defined, may be recognized or continue to be recognized upon adoption of FIN 48. The cumulative effect of applying the interpretation for the first time is reported as an adjustment to the opening balance of retained earnings for that fiscal year, presented separately. This interpretation is effective for fiscal years beginning after December 15, 2006.³

.147 For calendar year corporations, the new rules would seem to initially take effect with first quarter 2007 results. However, the new rules require calendar year corporations to have a "clean" starting point for their tax accounts at January 1, 2007. In other words, the deferred tax asset and deferred tax liability accounts on that date must be determined in accordance with the standards

³ FASB has proposed a 1 year deferral of the effective date of FIN 48 for nonpublic entities, including nonprofit organizations, to fiscal years beginning after December 15, 2007. Readers should be alert for further developments.

of FIN 48. Note that companies that do not file quarterly reports may be able to put compliance off for a year.

.148 The IRS has recognized that some taxpayers may wish to request a greatly accelerated examination and resolution before the end of their current fiscal year of "uncertain tax positions" taken in filed returns or expected to be taken in tax returns yet to be filed, or both. According to information received by the AICPA, the IRS has put procedures in place to quickly respond to taxpayer requests to resolve some uncertain tax positions prior to the end of their current fiscal year. The IRS has provided guidance and direction to field teams for taxpayers under examination which can be viewed online at www.irs.gov/businesses/corporations/article/0,,id=163496,00.html. The IRS has also established procedures for taxpayers whose returns are not under examination as well as for taxpayers whose returns have not yet been filed.

.149 Practitioners may find it helpful to refer to the recently issued AICPA *Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48*, which includes highlights of the interpretation and its implications for in-house accountants, auditors, and tax advisers. It is not authoritative, but is intended to assist practitioners in quickly understanding the requirements of FIN 48. The practice guide can be accessed online at www.tax.aicpa.org/Resources/Professional+Standards+and+Ethics/Practice+Guide+on+Accounting+for+Uncertain+Tax+Positions+Under+FIN+48.htm.

Other Guidance

Statement of Position 07-1, Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies

.150 This Statement of Position (SOP) provides guidance for determining whether an entity is within the scope of the AICPA Audit and Accounting Guide *Investment Companies* (guide). For those entities that are investment companies under this SOP:

- The provisions of the guide should be used in presenting the financial statements.
- The guide should be utilized to determine whether the accounting principles of the guide should be retained by a parent company in consolidation or by an investor that has the ability to exercise significant influence over the investment company and applies the equity method of accounting to its investment in the entity (equity method investor).
- Certain disclosures are required by parent companies and equity method investors in investment companies that retain investment company accounting in the parent company consolidated financial statements or the financial statements of an equity method investor.

.151 This guidance was to be effective for years beginning on or after December 15, 2007. However, at its October 17, 2007 Board meeting, FASB proposed to indefinitely defer the effective date of SOP 07-1 to enable FASB

staff to address certain implementation issues that have been brought to their attention. In addition, for entities that have not yet adopted the provisions of SOP 07-1, early adoption will be prohibited. These decisions will be documented in a proposed FASB Staff Position that will have a 30 day comment period. Readers should be alert for further developments.

FASB Staff Position FIN 39-1

.152 FASB Staff Position (FSP) FIN 39-1, *Amendment of FASB Interpretation No. 39*, is effective for fiscal years beginning after November 15, 2007. This FSP amends paragraph 3 of Interpretation 39, *Offsetting of Amounts Related to Certain Contracts*, to replace the terms *conditional contracts* and *exchange contracts* with the term *derivative instruments*, as defined in FASB Statement No. 133. It also amends paragraph 10 of Interpretation 39 to permit an entity to offset fair value amounts recognized for the right to reclaim cash collateral, or the obligation to return cash collateral, against fair value amounts recognized for derivative instruments executed with the same counterparty under the same master netting arrangement. See www.fasb.org/pdf/fsp_fin39-1.pdf.

FASB Staff Position EITF 00-19-2

.153 FSP EITF 00-19-2, *Accounting for Registration Payment Arrangements*, is effective for financial statements issued for fiscal years beginning after December 15, 2006, and interim periods within those fiscal years. This FSP clarifies that a contingent obligation to make future payments, or otherwise transfer consideration under a registration payment arrangement, should be separately recognized and measured in accordance with FASB Statement No. 5. This accounting treatment applies in situations where the registration payment arrangement is issued as a separate agreement and also in situations where the arrangement is included as a provision of a financial instrument or other agreement. See www.fasb.org/pdf/fsp_eitf00-19-2.pdf.

Statement 133 Implementation Issue No. B40

.154 Statement 133 Implementation Issue No. B40, *Embedded Derivatives: Application of Paragraph 13(b) to Securitized Interest in Prepayable Financial Assets*, sets forth the circumstances where a securitized interest in prepayable financial assets would not be subject to the conditions in paragraph 13(b) of FASB Statement No. 133. The objective of the guidance is to provide a narrow scope exception from paragraph 13(b) for securitized interests that contain only an embedded derivative that is tied to the prepayment risk of the underlying prepayable financial assets and that meet the criteria set forth. See the full text of the guidance online at www.fasb.org/derivatives/issueb40.shtml for complete information.

Statement 133 Implementation Issue No. G26

.155 Statement 133 Implementation Issue No. G26, *Cash Flow Hedges: Hedging Interest Cash Flows on Variable-Rate Assets and Liabilities That are not Based on a Benchmark Interest Rate*, clarifies two situations related to variable-rate financial assets or liabilities for which the interest rate is not based solely on an index. The issue addressed relates to situations where the interest rate is set through an auction process. Please see the full text of the

guidance online at www.fasb.org/derivatives/issueg26.shtml for complete information.

AICPA Technical Practice Aid, Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments, working draft as of December 1, 2006

.156 This working draft was prepared by the Analyzing Convertible Debt, Convertible Preferred Shares, Warrants, and Other Equity-Related Financial Instruments Task Force and the staff of the AICPA. Its content reflects what the authors believe is existing authoritative literature as of December 1, 2006. Readers are reminded that there are several projects currently in process at the FASB that may affect the contents of this Technical Practice Aid draft, and they must be alert to any changes. This draft has not been approved, disapproved, or otherwise acted on by any senior technical committee of the AICPA, the FASB, or the staff of the SEC and has no official or authoritative status.

.157 This Technical Practice Aid draft is not intended to provide practitioners with interpretative guidance or to describe the accounting for specific instruments. Rather, it is intended to assist practitioners in identifying the scope of and the interrelationships between the various relevant accounting pronouncements. To accomplish that goal, the practice aid is a roadmap addressing the accounting considerations that should be considered in analyzing freestanding and embedded derivative financial instruments at issuance and on an ongoing basis.

.158 This working draft is available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/Working+Draft+of+Convertible+Debt+Convertible+Preferred+Shares+Warrants+and+Other+Equi.htm.

Recent Auditing and Attestation Pronouncements and Related Guidance

.159 Presented in the following table is a list of recently issued auditing and attestation pronouncements and related guidance. For information on auditing and attestation standards issued subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing. You may also look for announcements of newly issued standards in the *CPA Letter*, *Journal of Accountancy*, and in the quarterly electronic newsletter, *In Our Opinion*, issued by the AICPA Auditing Standards team, available at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Opinion. As a reminder, AICPA auditing and attestation standards are applicable only to audits and attestation engagements of nonissuers.

.160 The PCAOB establishes auditing and attestation standards for audits of issuers. Refer to the PCAOB Web site at www.pcaob.org for information about its activities. You may also review the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), which summarizes recent developments at both the SEC and PCAOB. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online to www.cpa2biz.com.

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

<p>SAS No. 114, <i>The Auditor's Communication With Those Charged With Governance</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 380)</p> <p>Issue Date: December 2006</p> <p>(Applicable to audits conducted in accordance with generally accepted auditing standards [GAAS])</p>	<p>This standard replaces SAS No. 61, <i>Communication With Audit Committees</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 380A). The standard requires the auditor to conduct two-way communication with those charged with governance about certain significant matters related to the audit and also establishes standards and provides guidance on which matters should be communicated, who they should be communicated to, and the form and timing of the communication. It is effective for audits of financial statements for periods beginning on or after December 15, 2006.</p>
<p>SAS No. 113, <i>Omnibus Statement on Auditing Standards—2006</i> (AICPA, <i>Professional Standards</i>, vol. 1)</p> <p>Issue Date: November 2006</p> <p>(Applicable to audits conducted in accordance with GAAS)</p>	<p>This standard does the following:</p> <ul style="list-style-type: none">• Revises the terminology used in the 10 standards of SAS No. 95, <i>Generally Accepted Auditing Standards</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 150A), to reflect terminology in SAS No. 102, <i>Defining Professional Requirements in Statements on Auditing Standards</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 120)• Adds a footnote to the headings before paragraphs 35 and 46 in SAS No. 99, <i>Consideration of Fraud in a Financial Statement Audit</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 316), to provide a clear link between the auditor's consideration of fraud and the auditor's assessment of risk and the auditor's procedures in response to those assessed risks• Replaces throughout the SASs the term <i>completion of fieldwork</i> with the term <i>date of the auditor's report</i>• Changes the convention for dating the representation letter by requiring that it be dated as of the date of the auditor's report

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

<p>SAS No. 112, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 325)</p> <p>Issue date: May 2006</p> <p>(Applicable to audits conducted in accordance with GAAS)</p>	<p>This standard supersedes SAS No. 60, <i>Communication of Internal Control Related Matters Noted in an Audit</i>. It establishes requirements and provides extensive guidance about communicating matters related to an entity's internal control over financial reporting identified while performing an audit of financial statements. SAS No. 112 also requires that certain communications be in writing. It is effective for periods ending on or after December 15, 2006.</p>
<p>SAS Nos. 104–111, the risk assessment standards</p> <p>Issue Date: March 2006</p> <p>(Applicable to audits conducted in accordance with GAAS)</p>	<p>See the "AICPA Risk Assessment Standards" section in this alert.</p>
<p>Statement on Standards for Attestation Engagements (SSAE) No. 14, <i>SSAE Hierarchy</i> (AICPA, <i>Professional Standards</i>, vol. 1, AT sec. 50)</p> <p>Issue Date: November 2006</p>	<p>This SSAE identifies the body of attestation literature, clarifies the authority of attestation publications issued by the AICPA and others, specifies the extent of familiarity a practitioner needs to have with various kinds of attestation publications when conducting an attestation engagement, and amends the 11 attestation standards to reflect the terminology used in SSAE No. 13, <i>Defining Professional Requirements in Statements on Standards for Attestation Engagements</i> (AICPA, <i>Professional Standards</i>, vol. 1, AT sec. 20). It is effective when the subject matter or assertion is as of or for a period ending on or after December 15, 2006.</p>

(continued)

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

<p>Interpretation No. 1, "Communicating Deficiencies in Internal Control Over Compliance in an Office of Management and Budget (OMB) Circular A-133 Audit" (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 9325.01–.04), which interprets AU section 325, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i>, vol. 1)</p> <p>Issue Date: July 2007 (Interpretive publication)</p>	<p>This auditing interpretation interprets AU section 325, <i>Communicating Internal Control Related Matters Identified in an Audit</i> (AICPA, <i>Professional Standards</i>, vol. 1), and addresses how the definitions of the terms <i>control deficiency</i>, <i>significant deficiency</i>, and <i>material weakness</i> should be adapted and applied in the context of reporting on internal control over compliance in a single audit.</p>
<p>Interpretation No. 1, "Use of Electronic Confirmations" (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 9330.01–.06), which interprets AU section 330, <i>The Confirmation Process</i> (AICPA, <i>Professional Standards</i>, vol. 1)</p> <p>Issue Date: March 2007 (Interpretive publication)</p>	<p>This auditing interpretation interprets AU section 330, <i>The Confirmation Process</i> (AICPA, <i>Professional Standards</i>, vol. 1), and addresses the issue of electronic confirmations.</p>
<p>AICPA Technical Practice Aid (TPA) Technical Questions and Answers (TIS) section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, <i>Technical Practice Aids</i>)</p> <p>Issue Date: May 2007 (Nonauthoritative)</p>	<p>This question and answer discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. The question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations.</p>

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

<p>TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, <i>Technical Practice Aids</i>) Issue Date: May 2007 (Nonauthoritative)</p>	<p>This question and answer discusses whether the provisions of SAS No. 103, <i>Audit Documentation</i> (AICPA, <i>Professional Standards</i>, vol. 1, AU sec. 339), related to documentation completion and retention, apply to current year audit documentation maintained in the permanent file. The question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or, for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.</p>
<p>AICPA Professional Issues Task Force (PITF) Practice Alert (PA) 03-1, <i>Audit Confirmations</i> (AICPA, <i>Technical Practice Aids</i>, PA sec. 16,240) Revised: June 2007 (Nonauthoritative)</p>	<p>This PA responds to practitioners' current concerns about audit confirmations and includes discussion of improving confirmation response rates, negative versus positive confirmation requests, nonresponses to positive confirmations, responses to positive confirmation requests indicating exception, and use of electronic confirmations among other topics.</p>
<p>AICPA PITF PA 07-1, <i>Dating of the Auditor's Report and Related Practical Guidance</i> (AICPA, <i>Technical Practice Aids</i>, PA sec. 16,290) Issue Date: January 2007 (Nonauthoritative)</p>	<p>This PA provides guidance regarding application of certain provisions of SAS No. 103, primarily related to dating the auditor's report.</p>
<p>PCAOB Auditing Standard No. 5, <i>An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements</i> Issue Date: July 2007 (Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This standard replaces the PCAOB's previous internal control standard, Auditing Standard No. 2, <i>An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit of Financial Statements</i>. This principles-based auditing standard is designed to increase the likelihood that material weaknesses in internal control will be found before they result in material misstatement of a company's financial statements, and, at the same time, eliminate procedures that are unnecessary.</p>

(continued)

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

	<p>Auditing Standard No. 5 is required to be used by registered audit firms for all audits of internal control over financial reporting no later than for fiscal years ending on or after November 15, 2007. Earlier adoption is permitted and encouraged.</p>
<p>PCAOB Rule 3525, <i>Audit Committee Pre-approval of Non-audit Services Related to Internal Control Over Financial Reporting</i></p> <p>Issue Date: July 2007</p> <p>(Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This rule requires a registered public accounting firm that seeks pre-approval of an issuer audit client's audit committee to perform internal control-related nonaudit services that are not otherwise prohibited by the act or the rules of the SEC or the PCAOB to describe, in writing, to the audit committee the scope of the proposed service, discuss with the audit committee the potential effects of the proposed service on the firm's independence, and document the substance of the firm's discussion with the audit committee. These requirements parallel the auditor's responsibility in seeking audit committee preapproval to perform tax services for an audit client under PCAOB Rule 3524. This rule is effective for audits of fiscal years ending on or after November 15, 2007.</p>
<p>PCAOB Conforming Amendments to the Interim Auditing Standards</p> <p>Issue Date: July 2007</p> <p>(Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments can be found in Appendix 3 of PCAOB Release No. 2007-005A at www.pcaob.org/Rules/Docket_021/2007-06-12_Release_No_2007-005A.pdf.</p> <p>These amendments are effective for audits of fiscal years ending on or after November 15, 2007, the same effective date of Auditing Standard No. 5.</p>

***Recent Auditing and Attestation Pronouncements and
Related Guidance***

<p>PCAOB Report, <i>Report on the Second-Year Implementation of Auditing Standard No. 2, An Audit of Internal Control Over Financial Reporting Performed in Conjunction with an Audit of Financial Statements</i></p> <p>Issue Date: April 2007</p> <p>(Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This report is based on PCAOB inspections that looked at parts of approximately 275 audits of internal control over financial reporting by registered public accounting firms. Inspections focused on four areas: integrating the audits of financial statements and internal control, using a top-down approach, using the work of others, and assessing risk.</p>
<p>PCAOB Report, <i>Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud</i> (AICPA, PCAOB Standards and Related Rules, Select SEC-approved PCAOB Releases)</p> <p>Issue Date: January 2007</p> <p>(Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>This report focuses on aspects of the PCAOB's interim auditing standards that address the auditor's responsibility with respect to fraud, specifically AU section 316, <i>Consideration of Fraud in a Financial Statement Audit</i> (AICPA, PCAOB Standards and Related Rules). This report does not change or propose to change any existing standard nor is the PCAOB providing any new interpretation of existing standards.</p>
<p>PCAOB Staff Questions and Answers, <i>Ethics and Independence Rules Concerning Independence, Tax Services, and Contingent Fees</i></p> <p>Issue Date: April 2007</p> <p>(Applicable to audits conducted in accordance with PCAOB standards)</p>	<p>Topics covered include the following:</p> <ul style="list-style-type: none"> • The application of Rule 3522 (a) when conditions of confidentiality are imposed by tax advisors who are not employed by or affiliated with the registered public accounting firm • Whether a public accounting firm can advise an audit client on the tax consequences of structuring a particular transaction • Whether a registered public accounting firm's independence is affected by the IRS's subsequent listing of a transaction that the firm marketed, planned, or opined in favor of, as described in Rule 3522(b)

(continued)

<i>Recent Auditing and Attestation Pronouncements and Related Guidance</i>	
	<ul style="list-style-type: none">• Clarification that the auditor must evaluate whether a person is in a financial reporting oversight role at affiliates and not just the audit client itself• Clarification of the term <i>other change in employment event</i> as it relates to Rule 3522(c)
PCAOB Staff Questions and Answers, <i>Auditing the Fair Value of Share Options Granted to Employees</i> (AICPA, PCAOB Standards and Related Rules, PCAOB Staff Guidance, "Section 100—PCAOB Staff Questions and Answers") Issue Date: October 2006 (Applicable to audits conducted in accordance with PCAOB standards)	The guidance provides direction for auditing a company's estimation of the fair value of stock options granted to employees pursuant to FASB Statement No. 123 (revised 2004), <i>Share-Based Payment</i> , which became applicable for financial statements of companies with fiscal years ending on or after June 15, 2006.

The Auditor’s Communication With Those Charged With Governance

.161 In December 2006, the Auditing Standards Board (ASB) issued SAS No. 114, *The Auditor's Communication With Those Charged With Governance* (AICPA, *Professional Standards*, vol. 1, AU sec. 380), which supersedes SAS No. 61, *Communication With Audit Committees* (AICPA, *Professional Standards*, vol. 1, AU sec. 380A). The new SAS establishes standards and provides guidance to auditors on matters required to be communicated with those charged with governance in relation to an audit of financial statements and is effective for audits of financial statements for periods beginning on or after December 15, 2006. SAS No. 61 established communication requirements applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee. However, SAS No. 114 broadens the applicability of the SAS to audits of the financial statements of all nonissuers regardless of size, ownership, or organizational structure.

.162 SAS No. 114 recognizes the importance of effective two-way communication to the audit. It provides a framework for the auditor's communication with those charged with governance and identifies specific matters to be communicated, many of which are generally consistent with the requirements in SAS No. 61. However, SAS No. 114 does include certain additional matters to be communicated and provides additional guidance on the communication process. Among other matters, SAS No. 114 adds requirements to communicate an overview of the planned scope and timing of the audit. It also requires

significant matters communicated with those charged with governance to be documented.

Identifying Those Charged With Governance

.163 The SAS uses the term *those charged with governance* to refer to those with responsibility for overseeing the strategic direction of the entity and obligations related to the accountability of the entity, including overseeing the entity's financial reporting process. The SAS uses the term *management* to refer to those who are responsible for achieving the objectives of the enterprise and who have the authority to establish policies and make decisions by which those objectives are to be pursued.

.164 The auditor should determine the appropriate person(s) within the entity's governance structure with whom to communicate. The appropriate person(s) may vary depending on the matter to be communicated. Governance structures vary by entity, reflecting influences such as size and ownership characteristics.

.165 Because there is such diversity, it is not possible for SAS No. 114 to specify for all audits the person(s) with whom the auditor is to communicate particular matters. Furthermore, in some cases, the appropriate person(s) with whom to communicate may not be clearly identifiable from the engagement circumstances, for example, entities where the governance structure is not formally defined, such as some family-owned entities, some not-for-profit organizations, and some government entities. The auditor's understanding of the entity's governance structure and processes obtained in accordance with SAS No. 109, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement* (AICPA, *Professional Standards*, vol. 1, AU sec. 314), is relevant in deciding with whom to communicate matters. When the appropriate person(s) with whom to communicate are not clearly identifiable, the auditor and the engaging party should agree on the relevant person(s) within the entity's governance structure with whom the auditor will communicate.

Communicating Internal Control Related Matters Identified in an Audit

.166 In May 2006, the AICPA ASB issued SAS No. 112, *Communicating Internal Control Related Matters Identified in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325). SAS No. 112 establishes standards and provides guidance on communicating matters related to an entity's internal control over financial reporting (internal control) identified in an audit of financial statements. SAS No. 112 supersedes SAS No. 60, *Communication of Internal Control Related Matters Noted in an Audit*, as amended. The new SAS is applicable whenever an auditor expresses an opinion on financial statements (including a disclaimer of opinion) and is effective for audits of financial statements for periods ending on or after December 15, 2006. Among other things, SAS No. 112 does the following:

- Requires the auditor to communicate control deficiencies that are *significant deficiencies* or *material weaknesses* in internal control. The terms are defined in the SAS. The term *reportable condition* is no longer used. When SAS No. 112 was issued, the terms *significant deficiencies* and *material weaknesses* were consistent with PCAOB Auditing Standard No. 2, *An Audit of Internal Control Over Financial Reporting Performed in Conjunction With an Audit*

of *Financial Statements*. However, with the adoption of PCAOB Auditing Standard No. 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements*, the PCAOB redefined these terms, which now differ from SAS No. 112.

- Provides guidance on evaluating the severity of control deficiencies identified in an audit of financial statements and requires that the auditor conclude whether prudent officials, having knowledge of the same facts and circumstances, would agree with the auditor's classification of the deficiency.
- Identifies areas in which control deficiencies ordinarily are to be evaluated as at least significant deficiencies, and identifies indicators that control deficiencies should be regarded as at least a significant deficiency and a strong indicator of a material weakness.
- Requires the auditor to communicate significant deficiencies and material weaknesses identified in the audit, in writing, to management and those charged with governance. This includes the significant deficiencies and material weaknesses that were communicated in previous audits if they have not yet been remediated.
- Indicates that the communication must be in writing and is best made by the report release date (the date on which the auditor grants permission for the client to use the auditor's report in connection with the financial statements), but should be made no later than 60 days following the report release date.
- Contains illustrative written communications to management and those charged with governance.

How Revisions of SAS No. 112 Affect Practice

.167 As auditors gain a better understanding of what needs to be communicated to management and those charged with governance, there may be more control deficiencies that are identified as significant deficiencies and material weaknesses, and that are then communicated to management and those charged with governance. Auditors may emphasize and therefore spend more time evaluating identified control deficiencies than in the past.

Discussions With Management and Others

.168 The new requirements of SAS No. 112 may change perceptions regarding the auditor's role in the client's internal control. Auditors may have to explain to clients that the auditor *cannot* be a part of their internal control. Only the client—not the auditor—can correct control deficiencies. However, a CPA firm other than the auditor who does not provide attest services for the client can be part of a client's internal control. This may raise new questions regarding the role of outsourcing in achieving management's internal control objectives.

.169 Auditors may be called upon to hold discussions with management and other users of the auditor's written communication, such as regulators, to explain why the nature and extent of the internal control matters communicated to management and those charged with governance are different from the matters communicated in prior years. One reason is that the criteria have changed because of the introduction of the term *significant deficiencies* and its

definition as well as a new definition of material weaknesses. Another reason is that auditors have to include significant deficiencies and material weaknesses, identified and communicated in previous years, in written communication as long as these deficiencies have not been remediated. Auditors may need to explain to management and other users that the auditors are required to inform them of the significant deficiencies and material weaknesses every year as long as those deficiencies still exist.

.170 Auditors may also need to hold discussions with management and other users who ask how the auditors were able to express an unqualified opinion on the financial statements when material weaknesses in internal control were present. Auditors may wish to explain that the audit was designed to provide reasonable assurance that the financial statements are free from material misstatements. Internal control should be designed to prevent or detect material misstatements. As previously stated, the auditor cannot be part of a client's internal control system. Auditors can express an unqualified opinion on the financial statements even though material weaknesses in internal control are present because sufficient procedures were performed and appropriate audit evidence was obtained to afford reasonable assurance that the financial statements are free from material misstatement. However, these procedures do not *correct or remediate* control deficiencies; the deficiencies in internal control could still result in a material misstatement not being prevented, detected, and corrected by the client.

Issues for Audits of Smaller Entities

.171 One issue that has arisen in audits of smaller entities is the increase in costs as a result of the time the auditor spends documenting his or her evaluation of internal control and evaluating identified control deficiencies.

.172 Another issue that has caused concern is the extent to which the auditor may be involved in the drafting of an entity's financial statements. It is a strong indication of a material weakness in internal control if a client has ineffective controls over the preparation of its financial statements such that client controls are absent or controls are not effective in preventing, detecting, or correcting material misstatements in the preparation of financial statements, including the related notes. Although the auditor can propose adjustments and assist in assembling or drafting the financial statements, the auditor cannot establish or maintain the client's controls, including monitoring ongoing activities, because doing so would impair independence.⁴ How an auditor responds to a client's internal control weakness, in terms of designing and carrying out auditing procedures, does not affect or mitigate a client's internal control weakness. Just as an auditor's response to detection risk is independent of the client's control risk, so too the auditor's response to a client's control weakness by assisting in drafting the financial statements does not change that control weakness.

.173 The new requirements of SAS No. 112 introduce possible opportunities for auditors. Auditors can help clients evaluate the cost-benefit implications of improving their internal control, including training their personnel to be more knowledgeable. Auditors can also teach clients how to develop a risk assessment approach to designing internal control. Readers should also note

⁴ See Ethics Ruling 101-3, "Performance of nonattest services," of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 101.05).

that the Internal Control Task Force of the ASB is revising SAS No. 112 in response to the adoption of PCAOB Auditing Standard No. 5 and International Standards on Auditing.

.174 The AICPA has published the AICPA Audit Risk Alert titled *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk) to assist in implementation of this SAS. This Audit Risk Alert provides specific case studies to help determine whether identified control weaknesses would constitute a significant deficiency or material weakness; it can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

AICPA Risk Assessment Standards

.175 In March 2006, the AICPA ASB issued eight SASs referred to as the risk assessment standards (SAS Nos. 104–111). Although the SASs include many of the underlying concepts and detailed performance requirements contained in existing standards, they do create significant new requirements for the auditor. The risk assessment standards provide extensive guidance on how to apply the audit risk model when planning and performing financial statement audits, focusing on identifying and assessing the risks of material misstatements, further designing and performing tailored audit procedures in response to the assessed risks at relevant assertion levels, and improving the linkage between the risks, controls, audit procedures, and conclusions. The risk assessment standards are effective for audits of financial statements for periods beginning on or after December 15, 2006, with earlier application permitted. The following table lists the eight SASs and their effects on existing standards.

<i>Statement on Auditing Standards</i>	<i>Effect on Existing Standards</i>
SAS No. 104, <i>Amendment to Statement on Auditing Standards No. 1, Codification of Auditing Standards and Procedures ("Due Professional Care in the Performance of Work")</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 230)	This statement amends SAS No. 1, <i>Due Professional Care in the Performance of Work</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 230A).
SAS No. 105, <i>Amendment to Statement on Auditing Standards No. 95, Generally Accepted Auditing Standards</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 150)	This statement amends SAS No. 95, <i>Generally Accepted Auditing Standards</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 150A).
SAS No. 106, <i>Audit Evidence</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 326)	This statement supersedes SAS No. 31, <i>Evidential Matter</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 326A).
SAS No. 107, <i>Audit Risk and Materiality in Conducting an Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 312)	This statement supersedes SAS No. 47, <i>Audit Risk and Materiality in Conducting an Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 312A).

<i>Statement on Auditing Standards</i>	<i>Effect on Existing Standards</i>
SAS No. 108, <i>Planning and Supervision</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 311)	This statement supersedes SAS No. 1, <i>Appointment of the Independent Auditor</i> (AICPA, <i>Professional Standards</i> , AU sec. 310), and supersedes SAS No. 22, <i>Planning and Supervision</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 311A).
SAS No. 109, <i>Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 314)	This statement supersedes SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 319).
SAS No. 110, <i>Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 318)	This statement supersedes SAS No. 45, <i>Substantive Tests Prior to the Balance Sheet Date</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 313), and together with SAS No. 109, supersedes SAS No. 55, <i>Consideration of Internal Control in a Financial Statement Audit</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 319).
SAS No. 111, <i>Amendment to Statement on Auditing Standards No. 39, Audit Sampling</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 350)	This statement amends SAS No. 39, <i>Audit Sampling</i> (AICPA, <i>Professional Standards</i> , vol. 1, AU sec. 350A).

Key Provisions of the Risk Assessment Standards

.176 Whether due to error or fraud, the new risk assessment standards require the auditor to understand and respond to the risks of material misstatement. That understanding should identify risks that may lead to a material misstatement in the client's financial statements and any mitigating controls in place. The risk assessment standards place an even greater emphasis on the understanding and testing of internal control. Auditors may no longer simply default to a maximum control risk. Although this does not mean auditors are required to test and rely on controls as part of their audit strategy, they should assess how all five components of internal control over financial reporting relate to the client that they are auditing (see the Committee on Sponsoring Organizations of the Treadway Commission's [COSO] framework, www.coso.org/key.htm). These standards may significantly affect the formality of your risk assessment and documentation and may vary greatly from what auditors have previously done. Implementation of the SASs will most likely result in significant changes to firm audit methodologies and the training of personnel. Therefore, it is recommended that auditors allow ample time in advance of the required implementation date. Readers can obtain the SASs and

the related AICPA Audit Risk Alert titled *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk) by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

Companion Audit Guide

.177 In December 2006, the AICPA published the Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (product no. 012456kk). This guide helps auditors understand and implement the risk assessment standards. It includes practical guidance, examples, and an in-depth case study. The guide can be ordered by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com.

Other Audit Developments

Audit Documentation Technical Practice Aids

.178 In May 2007, the ASB issued two Technical Practice Aid (TPA) Technical Questions and Answers (TIS) related to SAS No. 103, *Audit Documentation* (AICPA, *Professional Standards*, vol. 1, AU sec. 339), which was issued in December 2005.

.179 TIS section 9100.06, "The Effect of Obtaining the Management Representation Letter on Dating the Auditor's Report" (AICPA, *Technical Practice Aids*), discusses whether the auditor is required to have the signed management representation letter in hand as of the date of the auditor's report. This question and answer indicates that although the auditor need not be in physical receipt of the representation letter on the date of the auditor's report, management will need to have reviewed the final representation letter and, at a minimum, have orally confirmed that they will sign the representation letter, without exception, on or before the date of the representations. The auditor will need to have the signed management representation letter in hand prior to releasing the auditor's report because management's refusal to furnish written representations constitutes a limitation on the scope of the audit sufficient to preclude an unqualified opinion.

.180 TIS section 8350.01, "Current Year Audit Documentation Contained in the Permanent File" (AICPA, *Technical Practice Aids*), discusses whether the provisions of SAS No. 103 related to documentation completion and retention apply to current year audit documentation maintained in the permanent file. This question and answer indicates that SAS No. 103 does apply to current year audit documentation maintained in a permanent file, or for that matter, maintained in any type of file, if the documentation serves as support for the current year's audit report.

Practice Alert No. 07-1, Dating of the Auditor's Report and Related Practical Guidance

.181 A key provision of SAS No. 103 is the amendment to paragraphs .01 and .05 of AU section 530, *Dating of the Independent Auditor's Report* (AICPA, *Professional Standards*, vol. 1), to require that the auditor's report not be dated earlier than the date on which the auditor has obtained sufficient appropriate audit evidence to support the opinion on the financial statements. As defined in the footnote to paragraph .01 of AU section 530, sufficient appropriate audit evidence includes, among other things, evidence that the audit documentation has been reviewed and that the entity's financial statements, including disclosures, have been prepared and that management has asserted that they have

taken responsibility for them. Application of the rules may require revising the process used by audit firms at the end of fieldwork to include a field review of the audit working papers and financial statements. For some firms, an additional visit to the client's office to update subsequent event analysis and management's representations may be required as well.

.182 The Professional Issues Task Force (PITF) issued this practice alert to provide guidance to auditors of nonissuers regarding the following:

- The audit report date
- Evidence supporting financial statement amounts and disclosures, specifically relating to attorney letters, obtaining waivers, and consideration and evaluation of subsequent events
- Financial statement preparation and management's assertions
- Evidence that the audit documentation has been reviewed

.183 Readers may access the practice alert at www.aicpa.org/download/auditstd/pract_alert/pa_2007_1.pdf.

PCAOB Auditing Standard No. 5

.184 On May 24, 2007, the PCAOB adopted Auditing Standard No. 5, which supersedes its Auditing Standard No. 2. Also adopted was an independence rule relating to the auditor's provision of internal control related nonaudit services and conforming amendment resulting from the issuance of PCAOB Auditing Standard No. 5. The SEC approved the standard on July 25, 2007.

.185 The PCAOB has closely monitored the implementation of Auditing Standard No. 2 and came to two conclusions:

1. The audit of internal control over financial reporting has produced significant benefits related to corporate processes and controls.
2. These benefits have come at a significant and higher than anticipated cost, and at times, the effort has appeared greater than necessary to conduct an effective audit of internal control over financial reporting.

.186 The PCAOB adopted the new Auditing Standard No. 5 to replace Auditing Standard No. 2 with the primary objective of focusing the auditor on matters most important to internal control. Goals of this new standard are to eliminate unnecessary procedures, to simplify and shorten the standard by reducing detail and specificity, and to make the audit more scalable for smaller and less complex companies. The following are some examples of important differences between Auditing Standard No. 5 and Auditing Standard No. 2:

- The new standard is less prescriptive, with fewer mandatory requirements and more reliance on auditor judgment.
- The new standard makes the audit scalable so it can change to fit the size and complexity of any company.
- The new standard directs the auditor to focus on what matters most and eliminates unnecessary procedures from the audit.
- The new standard includes a principles-based approach to determining when and to what extent the auditor can use the work of others.

.187 The adopted standard will do the following, among other things:

- Direct the auditor to the most important controls and emphasize the importance of risk assessment using a top-down approach
- Emphasize fraud controls, with an emphasis on assessing fraud risk in the planning process and additional guidance on the types of controls that may address fraud risk
- Identify management fraud as an area of higher risk, directing the auditor to focus more attention in this area
- Recalibrate the walkthrough requirement
- Permit consideration of knowledge obtained during prior audits
- Revise the definitions of significant deficiency and material weakness, as well as the "strong indicators" of a material weakness
- Adopt communication requirements, which require, among other things, that the auditor communicate, in writing, any material weaknesses identified to management and the audit committee, and to communicate any identified significant deficiencies, in writing, to the audit committee
- Direct the auditor to tailor the audit to reflect attributes of smaller and less complex companies
- Remove the requirement to evaluate management's process, which the PCAOB believes could contribute to a checklist approach to compliance by the auditors
- Provide auditors with further guidance regarding scoping decisions for multiple location audits

.188 Auditing Standard No. 5 is effective for audits of internal control over financial reporting required by Section 404(b) of the Sarbanes-Oxley Act of 2002 for fiscal years ending on or after November 15, 2007. Early adoption is permitted and encouraged. Please see www.pcaob.org/Standards/Standards_and_Related_Rules/Auditing_Standard_No.5.aspx for the full release document.

.189 Upon approval of the new standard by the SEC on July 25, 2007, the PCAOB announced that it is undertaking several initiatives to support the successful implementation of the standard. These initiatives include working closely with the audit firms early in their process as they evaluate how the new standard will affect their firms' audits of internal control. Other initiatives include continued outreach to public companies and smaller audit firms regarding the new standard. See full text of the press release at www.pcaob.org/News_and_Events/News/2007/07-25.aspx.

Rule 3525, Audit Committee Pre-Approval of Non-Audit Services Related to Internal Control Over Financial Reporting

.190 The PCAOB also adopted a new rule related to the auditor's responsibilities when seeking audit committee pre-approval of internal control related nonaudit services. The rule is intended to ensure that audit committees are provided relevant information for them to make an informed decision on how the performance of internal control-related services may affect independence. Specifically, the public accounting firm shall describe, in writing, the scope of the service and submit to the audit committee, as well as discuss with the audit committee, the potential effects of the service on the

firm's independence. Registered firms are also required to document the substance of such discussions in writing. This rule is effective for audits of fiscal years ending on or after November 15, 2007 (the same effective date as Auditing Standard No. 5). The full text of this rule can be found online at www.pcaob.org/Rules/Rules_of_the_Board/Rule_3525.pdf.

Conforming Amendments to Interim Auditing Standards

.191 In conjunction with the PCAOB's adoption of Auditing Standard No. 5, the PCAOB also adopted a number of conforming amendments to its interim standards. The conforming amendments due to the issuance of Auditing Standard No. 5 can be found online at www.pcaob.org/Rules/Rules_of_the_Board/Conforming_Amendments_AS5.pdf#page=1.

.192 For more information on PCAOB proposed rules and standards, please see *SEC and PCAOB Alert—2007/08*, which is available at www.cpa2biz.com.

Observations on Auditors' Implementation of PCAOB Standards Relating to Auditors' Responsibilities With Respect to Fraud

.193 On January 22, 2007, the PCAOB issued a report that addresses the auditors' responsibility as it relates to fraud, principally as it relates to AU Section 316, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *PCAOB Standards and Related Rules*). The PCAOB has identified areas (noted during the course of inspections) that auditors should focus on during the audit. The report is not changing any existing standards, but is focusing on areas that need special attention during an audit as it relates to fraud. Major topics discussed include the following:

- Auditors' overall approach to the detection of fraud
- Brainstorming sessions and fraud-related inquiries
- Auditors' response to fraud risk factors
- Financial statement misstatements
- Risk of management override of controls
- Other areas to improve fraud detection

.194 The full report can be accessed online at www.pcaob.org/Inspections/Other/2007/01-22_Release_2007-001.pdf.

Recent AICPA Independence and Ethics Pronouncements

.195 The AICPA *Independence and Ethics Alert—2007/08* (product no. 022478kk) contains a complete update on new independence and ethics pronouncements. This alert can be obtained by calling the AICPA at (888) 777-7077 or by going online at www.cpa2biz.com. Readers should obtain this alert to be aware of independence and ethics matters that will affect their practice.

Recent Accounting Pronouncements and Related Guidance

.196 Presented in the following table is a list of recently issued accounting pronouncements and related guidance. As indicated below, some of these items are described more fully in a prior section of this alert titled, "Accounting Issues and Developments." For information on accounting standards issued

subsequent to the writing of this alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and *Journal of Accountancy*.

<i>Recent Accounting Pronouncements and Related Guidance</i>	
FASB Statement No. 159 (February 2007)	<i>The Fair Value Option for Financial Assets and Financial Liabilities—Including an amendment of FASB Statement No. 115</i> See the information in "Fair Value Measurements" in the "Accounting Issues and Development" section of the alert.
FASB Statement No. 158 (September 2006)	<i>Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans—an amendment of FASB Statements No. 87, 88, 106, and 132(R)</i>
FASB Statement No. 157 (September 2006)	<i>Fair Value Measurements</i> See the information in "Fair Value Measurements" in the "Accounting Issues and Development" section of the alert.
FASB Interpretation No. 48 (June 2006)	<i>Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109</i> See the information the "Accounting Issues and Development" section of the alert.
FASB Emerging Issues Task Force (EITF) Issues (Various dates)	Go to www.fasb.org/eitf/agenda.shtml for a complete list of EITF Issues.
FASB Staff Positions (FSPs) (Various dates)	Go to www.fasb.org/fasb_staff_positions/ for a complete list of FSPs.
AICPA Statement of Position (SOP) 07-1 (AICPA, <i>Technical Practice Aids</i> , ACC sec. 10,930)	<i>Clarification of the Scope of the Audit and Accounting Guide Investment Companies and Accounting by Parent Companies and Equity Method Investors for Investments in Investment Companies</i> See the information in "Other Guidance" in the "Accounting Issues and Development" section of the alert.
AICPA Practice Guide (Nonauthoritative)	"Practice Guide on Accounting for Uncertain Tax Positions Under FIN 48"

.197 Of the accounting pronouncements and related guidance listed in the previous table, those having particular significance to the securities industry were briefly explained in the section of this alert titled "Accounting Issues and Developments."

On the Horizon

.198 Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Presented in the following sections is brief information about some ongoing projects that have particular significance to the securities industry or that may result in significant changes. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing existing standards.

.199 The following table lists the various standard-setting bodies' Web sites, where information may be obtained on outstanding exposure drafts, including downloading exposure drafts. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist in addition to those discussed here. Readers should refer to information provided by the various standard-setting bodies for further information.

<i>Standard-Setting Body</i>	<i>Web Site</i>
AICPA Auditing Standards Board (ASB)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/
Financial Accounting Standards Board (FASB)	www.fasb.org
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/Professional+Resources/Professional+Ethics+Code+of+Professional+Conduct/Professional+Ethics/
Securities and Exchange Commission (SEC)	www.sec.gov

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to service@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message. The AICPA Web site also has connecting links to the other standard-setting bodies listed here.

Auditing Pipeline—Nonissuers

Revision of AICPA Practice Aid, Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools

.200 The Commodity Practice Aid Task Force of the AICPA is in the process of revamping this practice aid to reflect changes in accounting and auditing guidance and regulatory rules that have occurred since the original issuance of this publication. The revised practice aid will provide practitioners with nonauthoritative, practical guidance on auditing financial statements of FCMs, IBs, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this practice aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools. Readers should be alert to further developments.

ASB Clarity Project

.201 The ASB has formed a Clarity Task Force to address concerns over the clarity, length, and complexity of generally accepted auditing standards. In March 2007, the ASB approved for exposure a discussion paper titled *Improving the Clarity of ASB Standards*. This discussion paper seeks feedback on proposed changes to the standards, including the following:

- Establishing objectives for each of the standards, and the auditor's obligations related to the objectives
- Structural and drafting improvements to make the standards easier to read and understand
- Inclusion, in the explanatory material of the standards, of special considerations related to audits of governmental entities and small entities
- Establishing a glossary of terms that would be presented in a separate section of the codification of the standards

.202 The period to comment ended June 15, 2007. The discussion paper can be accessed online at www.aicpa.org/download/auditstd/Clarity_of_ASB_Standards_Discussion_Memo.pdf.

Convergence With International Standards

.203 The ASB has created a number of task forces charged with monitoring specific activities of the International Auditing and Assurance Standards Board (IAASB) and working toward convergence with international auditing standards. The ASB has commented on several exposure drafts of International Standards on Auditing (ISA). The status of these and other ASB projects can be monitored online at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Audit+and+Attest+Standards/Auditing+Standards+Board/.

Proposed Statement on Standards for Attestation Engagements Regarding Reporting on an Entity's Internal Control Over Financial Reporting

.204 In January 2006, the ASB issued a revised exposure draft of a proposed Statement on Standards for Attestation Engagements (SSAE) that would

supersede Chapter 5, "Reporting on an Entity's Internal Control Over Financial Reporting," of SSAE No. 10, *Attestation Engagements: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 501), as amended. This proposed SSAE establishes standards and provides guidance to the practitioner who is engaged to issue or does issue an examination report on the effectiveness of an entity's internal control over financial reporting as of a point in time (or on an assertion thereon). As mentioned previously, in May 2007, the PCAOB adopted Auditing Standard No. 5, which replaces Auditing Standard No. 2. Knowing the forthcoming changes would be relevant to the revision of AT section 501, the ASB previously decided to defer to issuance of a final revised AT section 501 until the PCAOB issued its amendments, and the ASB had time to consider them. The Internal Control Task Force of the ASB is responsible for this revision. Readers may monitor progress on the AICPA Web site at www.aicpa.org.

Proposed Amendment to SAS No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles

.205 In May 2005, the ASB issued an exposure draft introducing a proposed SAS titled *Amendment to Statement on Auditing Standards No. 69, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*, for Nongovernmental Entities. This proposed SAS, which applies only to nongovernmental entities, has been issued in response to the FASB's proposed Statement of Financial Accounting Standards titled *The Hierarchy of Generally Accepted Accounting Principles*. The FASB proposal moves responsibility for the GAAP hierarchy for nongovernmental entities from the auditing literature (SAS No. 69, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles* [AICPA, *Professional Standards*, vol. 1, AU sec. 411]) to the accounting literature. The proposed SAS deletes the GAAP hierarchy for nongovernmental entities from SAS No. 69. The ASB decided to coordinate the provisions and effective date of this exposure draft with the proposed FASB statement, which can be obtained at www.fasb.org. The ASB will issue its final SAS coincidentally with the FASB's and PCAOB's issuance of their final standards.

Auditing Pipeline—Issuers

.206 Guidance issued by the PCAOB is included in the section of this alert titled "Recent Auditing and Attestation Pronouncements and Related Guidance." For more information regarding recent developments at both the SEC and PCAOB, readers may refer to the *SEC and PCAOB Alert—2007/08* (product no. 022498kk), mentioned previously.

Accounting Pipeline

.207 The following are accounting projects and pronouncements currently in process. Some of the proposed pronouncements discussed in the prior year alert have not been finalized as of the date of this writing, and thus are included again.

Business Combinations

.208 Phase one of the business combination project resulted in the issuance of FASB Statement No. 141, *Business Combinations*, and FASB Statement No. 142, *Goodwill and Other Intangible Assets*. In those statements, the FASB eliminated the use of the pooling of interests method of accounting for

business combinations and addressed purchase accounting guidelines for acquired intangible assets and goodwill and goodwill impairment. The objective of phase two of this project is to standardize business combination accounting through the convergence of the FASB and International Accounting Standards Board (IASB) accounting standards and by reconsidering the existing guidance for the purchase method of accounting for business combinations. Among the main proposals are the following:

- All acquisitions of businesses be measured at the fair value of the business acquired
- Substantially all the assets acquired and liabilities assumed of the acquired business be recognized and measured at their fair values at the acquisition date
- Entities that follow U.S. GAAP and international standards apply substantially the same accounting requirements for their business combinations

.209 In June 2005, the FASB and IASB issued a number of exposure drafts, for which comment periods ended in October 2005. Redeliberations began in January 2006 and were completed in June 2007. The FASB and IASB expect to issue final statements during the fourth quarter of 2007. Four standards are expected to be issued:

- Proposed FASB Statement No. 141(R) and International Financial Reporting Standard (IFRS) No. 3(R), *Business Combinations*
- Proposed FASB Statement No. 160, *Consolidated Financial Statements, Including Accounting and Reporting of Noncontrolling Interests in Subsidiaries*
- Proposed International Accounting Standard (IAS) Statement No. 27(R)

.210 Readers should remain alert to the final issuances and visit the FASB Web site for further information.

Fair Value

.211 During phase one of the FASB's fair value option project, the FASB issued FASB Statement No. 159, which was previously discussed. In phase two of the project, the FASB will consider allowing the fair value option for certain nonfinancial assets and nonfinancial liabilities and deposit liabilities of depository institutions, which are excluded from the scope of FASB Statement No. 159. Deliberations on phase two are expected to begin in the third quarter of 2007. Readers should remain alert to developments by visiting the FASB Web site.

Derivative Disclosures

.212 In December 2006, the FASB issued an exposure draft titled *Disclosures about Derivative Instruments and Hedging Activities—an amendment of FASB Statement No. 133*. The comment period for this exposure ended in March 2007, and the FASB has begun redeliberations to consider significant issues raised by respondents. The objective of this project is to provide guidance on enhanced disclosure requirements and balance sheet and income statement display of derivatives accounted for in accordance with FASB Statement No. 133, including how and why an entity uses derivative instruments; how derivative

instruments and related hedged items are accounted for under FASB Statement No. 133; and how derivative instruments affect an entity's financial position, results of operations, and cash flows. Readers can monitor the progress of this project on the FASB Web site.

Transfers of Financial Assets

.213 The FASB is working on a project to amend FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities—a replacement of FASB Statement No. 125*, to address issues related to the permitted activities of a qualifying special-purpose entity (QSPE), isolation criteria, and other issues that arose during redeliberations on the amendment of FASB Statement No. 140 to improve comparability of financial statements. In August 2005, the FASB issued the exposure draft *Accounting for Transfers of Financial Assets*, which was a revision of a June 2003 exposure draft. During 2007, the FASB expects to address issues related to the permitted activities of a QSPE and then issue another exposure draft during the fourth quarter of 2007 containing potential amendments to FASB Statement No. 140. See the FASB Web site for complete information.

Earnings Per Share

.214 The FASB and IASB have been working together to resolve differences between FASB Statement No. 128, *Earnings per Share*, and IAS Statement No. 33, *Earnings per Share*. This project is part of the larger FASB project, Short-term International Convergence, which has resulted in the issuance of a number of FASB Statements. Currently the FASB and IASB are addressing significant differences that remain relating to instruments that can be settled in cash or shares and are classified as a liability on an entity's balance sheet. The FASB and IASB are considering modifications to the treasury stock method and several scoping issues in which either the FASB or IASB has issued or may issue more detailed implementation guidance on earnings per share that may create a convergence difference. The FASB and IASB are expected to issue an exposure draft for public comment during the third quarter of 2007. This exposure draft will be the third exposure draft the FASB has issued on the earnings per share project. The project and current exposure draft can be reviewed on the FASB Web site.

FASB Codification and Retrieval Project

.215 The goal of this FASB project is to create a single, authoritative codification of U.S. GAAP. The codification will integrate and topically organize all relevant accounting guidance issued by the U.S. standard setters (FASB, AICPA, EITF, and the SEC). The codification will have a three layered structure: topic, subtopic, and section. The FASB has structured the topics into three primary areas: overall presentation, transactional (or financial statement account), and industry. The overall presentation area addresses presentation of financial information but does not address items such as recognition, measurement, or derecognition. The transactional or financial statement account area addresses accounting recognition, measurement, or derecognition. The industry area includes guidance unique to the industry. A codification draft is expected in 2007 and will have an extended verification period to ensure that it accurately reflects U.S. GAAP. Once the FASB addresses respondent comments, the codification will become the single authoritative source of U.S. GAAP and will supersede all existing standards. Readers can track

progress of the Codification and Retrieval Project on the FASB Web site at www.fasb.org/project/codification&retrieval_project.shtml.

GAAP Hierarchy

.216 This proposed statement would identify the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental companies that are presented in conformity with U.S. GAAP (or the GAAP hierarchy). The GAAP hierarchy is currently presented in AICPA SAS No. 69. However, the FASB believes that the GAAP hierarchy should be directed specifically to companies because it is the company, not the auditor, which is responsible for selecting its accounting principles for financial statements. Accordingly, the FASB concluded that the GAAP hierarchy should reside in the accounting literature established by the FASB. The FASB decided to carry forward the GAAP hierarchy as set forth in SAS No. 69, subject to certain modifications. The FASB staff will coordinate with the AICPA (as previously discussed in the "Auditing Pipeline—Nonissuers" section) to ensure that each of the documents has a uniform effective date. Readers should be alert for the issuance of a final statement.

Proposed FASB EITFs and FSPs

.217 *Proposed FASB EITF Issues.* Numerous open issues are under deliberation by the EITF. Proposed EITF issues that are closely related to the securities industry are listed in summary form. Readers should visit the FASB Web site at www.fasb.org/eitf/agenda.shtml for complete information.

EITF Issue No. 07-1, *Accounting for Collaborative Arrangements*

.218 EITF Issue No. 07-1 seeks to determine what type of arrangement constitutes a collaborative arrangement subject to these rules, how costs incurred and revenues generated on sales to third parties should be reported in the case of joint agreements, how sharing payments made to, or received by, a partner pursuant to a Collaboration Agreement should be presented in the Income Statement and what disclosures should be required by the parties to the arrangement. The text is available at www.fasb.org/eitf/0701DA.pdf.

.219 *Proposed FSPs.* A number of proposed FSPs are currently in progress. Proposed FSPs that are closely related to the securities industry are listed in summary form. Readers should visit the FASB Web site at www.fasb.org/fasb_staff_positions/ for complete information.

FSP APB 14-a

.220 This proposed FSP would clarify that convertible debt instruments that may be settled in cash upon conversion (including partial cash settlement) are not addressed by paragraph 12 of Accounting Principles Board (APB) Opinion No. 14, *Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants*. It would require that instruments within its scope be separated into their liability and equity components at initial recognition, and provides guidance on the attribution of proceeds at initial recognition and at settlement. Please see the full text of FSP APB 14-a at www.fasb.org/fasb_staff_positions/prop_fsp_apb14-a.pdf.

FSP FAS 140-d

.221 This proposed FSP states that a transfer of a financial asset and a repurchase agreement involving the transferred financial asset should be considered part of the same arrangement in situations where the counterparties to the two transactions are the same unless certain criteria are met. This FSP focuses on the circumstances that would permit the transferor and transferee to separately evaluate the accounting for a transfer of a financial asset and a repurchase financing under FASB Statement No. 140, *Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*. Please see the full text of FSP FAS 140-d at www.fasb.org/fasb_staff_positions/prop_fsp_fas140-d.pdf.

SEC Concept Release on Allowing U.S. Issuers to Prepare Financial Statements in Accordance with International Financial Reporting Standards

.222 The SEC published a release to obtain information about the public's interest in allowing U.S. issuers, including investment companies subject to the Investment Company Act of 1940, to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board. See Release No. 34-56217 for complete information.

Internal Control Pipeline

COSO Internal Control—Integrated Framework, Guidance on Monitoring Internal Control Systems

.223 COSO released a discussion document, *Guidance on Monitoring Internal Control Systems*, in September 2007 as part of their monitoring project. The document is intended to improve the understanding of the building blocks of effective monitoring, thereby improving both the efficiency and effectiveness of the entire system of internal control. The discussion document can be accessed online at www.coso.org/Publications/COSO_Monitoring_discussiondoc.pdf.

Resource Central

.224 The following are various resources that practitioners engaged in the securities industry may find beneficial.

Publications

.225 Practitioners may find the following publications useful with respect to the securities industry:

- Audit and Accounting Guide *Brokers and Dealers in Securities* (2007) (product no. 012707kk)
- Audit Guide *Analytical Procedures* (2007) (product no. 012557kk)
- Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (2006) (product no. 012456kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (2007) (product no. 012527kk)
- Audit Guide *Auditing Revenue in Certain Industries* (2007) (product no. 012517kk)

- Audit Guide *Audit Sampling* (2007) (product no. 012537kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, as Amended* (2007) (product no. 012777kk)
- AICPA *Audit Risk Alert—2007/08* (product no. 022338kk)
- Audit Risk Alert *Independence and Ethics Alert—2007/08* (product no. 022478kk)
- Audit Risk Alert *SEC and PCAOB Alert—2007/08* (product no. 022498kk)
- Audit Risk Alert *Understanding the New Auditing Standards Related to Risk Assessment* (product no. 022526kk)
- Audit Risk Alert *Understanding SAS No. 112 and Evaluating Control Deficiencies* (product no. 022536kk)
- *Audit and Accounting Manual* (2007) (product no. 005137kk)
- *Accounting Trends & Techniques, 61st Edition* (product no. 009899kk)

AICPA reSOURCE: Accounting and Auditing Literature

.226 The AICPA has created your core accounting and auditing library online. AICPA reSOURCE is now customizable to suit your preferences or your firm's needs. Or, if you prefer to have access to the entire library, that is available too. Get access—anytime, anywhere—to the AICPA's latest *Professional Standards*, TPAs, Audit and Accounting Guides (more than 20), Audit Risk Alerts (more than 15), and *Accounting Trends & Techniques*. To subscribe to this essential online service for accounting professionals, go to www.cpa2biz.com.

Continuing Professional Education

.227 The AICPA offers a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry, including the following:

- *AICPA's Annual Accounting and Auditing Update Workshop* (2007 Edition) (product no. 736183kk [text] or 187191 [DVD]). Whether you are in industry or public practice, this course keeps you current and informed and shows you how to apply the most recent standards.
- *SEC Reporting* (product no. 736774kk [text] or 186755 [DVD]). Confidently comply with the latest SEC reporting requirements with this comprehensive course. It clarifies new, difficult, and important reporting and disclosure requirements while giving you examples and tips for ensuring compliance.

.228 Among the many courses, the following are specifically related to the securities industry:

- *Implementing SOX 404: An Advanced Analysis* (product no. 737177kk). Provides information on understanding the requirements and how to effectively implement the provisions of SOX 404.
- *Management's Assessment of Internal Control* (product no. 181428kk). Based on hard-earned lessons learned by companies

that already have had to comply, this course will take management of both large and smaller public companies through the requirements of each major phase of the internal control assessment project.

.229 Visit www.cpa2biz.com for a complete list of CPE courses.

Online CPE

.230 AICPA CPEExpress (formerly AICPA InfoBytes), offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. AICPA CPEExpress now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay \$149 for a new subscription and \$119 for the annual renewal. Nonmembers pay \$369 for each. Divided into 1-credit and 2-credit courses that are available 24 hours a day, 7 days a week, AICPA CPEExpress offers hundreds of hours of learning in a wide variety of topics. Some topics of special interest to the securities industry include modules related to varying aspects of internal controls, PCAOB rules and regulations, and SEC reporting.

.231 To register or learn more, visit www.cpa2biz.com.

Industry Conference

.232 Co-sponsored by the AICPA and the Financial Management Division of the SIFMA, The National Conference on the Securities Industry is designed to update attendees on significant accounting, legal, financial, and tax developments affecting the securities industry. This two-day conference is held in late fall. For further information about the conference, call (888) 777-7077 or visit www.cpa2biz.com.

Webcasts

.233 Stay plugged in to what is happening and earn CPE credit right from your desktop. AICPA Webcasts are high quality, two-hour CPE programs that bring you the latest topics from the profession's leading experts. Broadcast live, they allow you to interact with the presenters and join in the discussion. If you cannot make the live event, each Webcast is archived and available on CD-ROM.

CFO Quarterly Roundtable Series

.234 The CFO Quarterly Roundtable Webcast Series, brought to you each calendar quarter, covers a broad array of "hot topics" that successful organizations employ and subjects that are important to the CFO's personal success. From financial reporting, budgeting, and forecasting to asset management and operations, the roundtable helps CFOs, treasurers, controllers, and other financial executives excel in their demanding roles.

SEC Quarterly Update Series

.235 The SEC Quarterly Update Webcast Series, brought to you each calendar quarter, showcases the profession's leading experts on what is "hot" at the SEC. From corporate accounting reform legislation and new regulatory initiatives to accounting and reporting requirements and corporate finance activities, these hard-hitting sessions will keep you "plugged in" to what is important. A must for preparers in public companies and practitioners who have public

company clients, this is the place to be when it comes to knowing about the areas of current interest at the SEC.

Member Service Center

.236 To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Service Operations Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

.237 Do you have a complex technical question about GAAP, other comprehensive bases of accounting, or other technical matters? If so, use the AICPA's Accounting and Auditing Technical Hotline. AICPA staff will research your question and call you back with the answer. You can reach the Technical Hotline at (877) 242-7212.

Ethics Hotline

.238 In addition to the Technical Hotline, the AICPA also offers an Ethics Hotline. Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. You can reach the Ethics Hotline at (888) 777-7077.

AICPA CAQ

.239 The CAQ (formerly the Center for Public Company Audit Firms) was created to serve investors, public company auditors, and the markets. The CAQ's mission is to foster confidence in the audit process and to aid investors and the capital markets by advancing constructive suggestions for change rooted in the profession's core values of integrity, objectivity, honesty, and trust.

.240 To accomplish this mission, the CAQ works to make public company audits even more reliable and relevant for investors in a time of growing financial complexity and market globalization. The CAQ also undertakes research, offers recommendations to enhance investor confidence and the vitality of the capital markets, issues technical support for public company auditing professionals, and helps facilitate the public discussion about modernizing business reporting. The CAQ is a voluntary membership center that supports member firms that audit or are interested in auditing public companies with education, communication, representation, and other means. To learn more about the CAQ, visit <http://thecaq.aicpa.org>.

AICPA Industry Expert Panel—Stockbrokerage and Investment Banking Expert Panel

.241 For information about the activities of the Stockbrokerage and Investment Banking Expert Panel, visit the AICPA Web site at www.aicpa.org/Professional+Resources/Accounting+and+Auditing/Accounting+Standards/expertpanel_stockbroker_investbank.htm.

Industry Web Sites

.242 The Internet covers a vast amount of information that may be valuable to auditors of securities entities, including current industry trends and developments. Some of the more relevant sites for auditors with securities clients include those shown in the following table.

Organization	Web Site
Commodity Futures Trading Commission (CFTC)	www.cftc.gov
Financial Crimes Enforcement Network (FinCEN)	www.fincen.gov
Financial Industry Regulatory Authority (FINRA)	www.finra.org
Futures Industry Association	www.futuresindustry.org
National Futures Association	www.nfa.futures.org
New York Stock Exchange, Inc. (NYSE)	www.nyse.com
Public Company Accounting Oversight Board (PCAOB)	www.pcaob.org
Securities and Exchange Commission (SEC)	www.sec.gov
Securities Industry and Financial Markets Association (SIFMA)	www.sifma.org

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.243 This Audit Risk Alert replaces *Securities Industry Developments—2006/07*.

.244 The Audit Risk Alert *Securities Industry Developments* is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Audit Risk Alert, please feel free to share them with us. Any other comments that you have about the Audit Risk Alert would also be appreciated. You may e-mail these comments to sreed@aicpa.org or write to:

Susan M. Reed, CPA
AICPA
220 Leigh Farm Road
Durham, NC 27707-8110

Appendix—Additional Web Resources

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Here are some useful Web sites that may provide valuable information to accountants.

<i>Web Site Name</i>	<i>Content</i>	<i>Web Site</i>
American Institute of CPAs (AICPA)	Summaries of recent auditing and other professional standards as well as other AICPA activities	www.aicpa.org www.cpa2biz.com
AICPA Accounting Standards Executive Committee (AcSEC)	Issues SOPs, guides, practice bulletins containing financial, accounting, and reporting recommendations, among other things	www.aicpa.org/ Professional+Resources/ Accounting+and+ Auditing/Accounting+ Standards
AICPA Accounting and Review Services Committee (ARSC)	Develops and issues review and compilation standards and interpretations	www.aicpa.org/ Professional+Resources/ Accounting+and+ Auditing/Audit+and+ Attest+Standards/ Accounting+and+ Review+Services+ Committee
AICPA Professional Issues Task Force (PITF)	Accumulates and considers practice issues that appear to present concerns for practitioners and for disseminating information or guidance, as appropriate, in the form of practice alerts	www.aicpa.org/ Professional+Resources/ Accounting+and+ Auditing/Audit+and+ Attest+Standards/ Professional+Issues+ Task+Force
Economy.com	Source for analysis, data, forecasts, and information on the United States and world economies	www.economy.com
The Federal Reserve Board	Key interest rates	www.federalreserve.gov
Financial Accounting Standards Board (FASB)	Summaries of recent accounting pronouncements and other FASB activities	www.fasb.org
USA.gov	Portal through which all government agencies can be accessed	www.usa.gov

<i>Web Site Name</i>	<i>Content</i>	<i>Web Site</i>
International Accounting Standards Board (IASB)	Summaries of International Financial Reporting Standards and International Accounting Standards	www.iasb.org
International Federation of Accountants (IFAC)	Information on standards-setting activities in the international arena	www.ifac.org
